



**Financial Services
Commission**

Insurance Guidance Note No. 5
Insurance Companies Ordinance 1987
Systems Of Control Over Investments (And
Counterparty Exposure) Including The Use Of
Derivatives

Date of Paper : 17 January 1997

Version Number : V1.00

File Location : document2



Table of Contents

Introduction.....	3
The New Regulatory Requirements	3
Sound And Prudent Management	3
Suitability Of Assets.....	4
Derivatives.....	4
Investment Strategy	4
Controls Over Exposures	5
The Investment Managers	5
Use Of Derivatives And Other Complex Investment Instruments.....	5
Resources Allocated	6
Reports To The Board.....	6
Further Guidance.....	6
ANNEX A - Monitoring Of Aggregate Exposures	7
Credit Exposure To Reinsurers	7
Insurance Groups	8
ANNEX B - Controls Over Investment Managers.....	9
ANNEX C - Controls Over Derivatives.....	11

Published by:

Financial Services Commission
 PO Box 940, Suite 943, Europort, Gibraltar
 Tel (+350) 40283
 Fax (+350) 40282
 E-Mail: info@fsc.gi
www.fsc.gi

Introduction

1. The new legislation which came into force on 1st July 1996 implementing fully the Third EC Life and Non-Life Insurance Directives introduced a number of new requirements - some in very general terms, others very specific to the use of derivatives - which impact on the systems and controls which insurance companies should have over their investments and counterparty exposure. In particular, Criteria of Sound and Prudent Management are now set out in Schedule 15 to the Ordinance. Paragraph 6(1)(b) of that Schedule reads:

The insurer shall not be regarded as conducting its business in a sound and prudent manner unless it maintains adequate systems of control of its business and records.

It is the responsibility of the directors to ensure that management has instituted the necessary controls to satisfy the new legal requirements.

2. It is for the company to take its own legal advice as to the application of these requirements to its own particular circumstances. This guidance note is not intended to be prescriptive. Rather, we believe that compliance with the guidance will, under normal circumstances, be sufficient to give reasonable assurance that controls over investments and counterparty exposure are "adequate". We accept both that absolute assurance cannot be achieved in practice and that different circumstances may demand different solutions to "adequate controls". Paragraphs 9-19, as amplified by the Annexes, constitute the guidance. The earlier paragraphs provide background explanatory material only.
3. The bulk of this guidance applies to investments generally (although some of the items will apply more widely, for example in relation to accumulated exposure to individual counterparties or to reinsurers). However, we lay particular stress on its applicability to the use of derivatives and other complex investment instruments, which have become increasingly common in recent years. The ready availability of such instruments presents significant opportunities for managing risk and portfolios more efficiently and for new product design. However, their use, if not properly controlled, could increase, rather than reduce, risk. In volatile market conditions, management faces added difficulties in analysing and controlling the effects of changes in interest rates, exchange rates and market prices. Inadequate monitoring in these areas may allow major unforeseen losses and runs counter to the need and regulatory requirement for insurance companies to be managed prudently.
4. Under paragraph 7 of Schedule 5 to the Insurance Companies (Accounts and Statements) Regulations 1996, the directors are required to list any published guidance with which the company's control systems comply. We regard this guidance as being relevant to that certificate in respect of all financial years ending on or after 1st January 1997.

The New Regulatory Requirements

5. There are three main areas where requirements, while not necessarily new, are more explicit than in the past. These are set out immediately below. The remainder of this guidance note deals both with general matters relating to investments and asset management, and in some detail with the controls we would expect to see where a company is using derivatives.

Sound And Prudent Management

6. Insurance business must be conducted in a sound and prudent manner. Two aspects of the criteria set out in Schedule 15 to the Ordinance are particularly

relevant here. Companies should have adequate systems of control to enable sound and prudent management. Moreover, business should be conducted with due regard to the interests of policyholders and potential policyholders. This reinforces the need for the adequacy of systems for the purposes of protecting policyholders' interests (including, in the case of long-term policyholders, their reasonable expectations).

Suitability Of Assets

7. Section 64B of the Ordinance now requires explicitly that the assets backing insurance liabilities satisfy the following conditions:
- ".....are of appropriate safety, yield and marketability having regard to the classes of business carried on"; and**
- ".....investments are appropriately diversified and adequately spread and that excessive reliance is not placed on investments of any particular category or description".**

Derivatives

8. Part II of the Insurance Companies (Valuation of Assets and Liabilities) Regulations 1996 introduces a framework for the use of derivatives. Rules on reporting are set out in the Insurance Companies (Accounts and Statements) Regulations 1996. On the latter point, companies are, in particular, required to disclose the broad investment guidelines operated during the year and provide a summary of exposures facing the company as a result of derivative transactions.

Investment Strategy

9. Suitable control and management information systems should be in place to enable the company to implement an appropriate investment strategy. Such a strategy should have due regard to the following:
- the implications of Section 21 of the Ordinance, insofar as that section is relevant to the matters covered by this Note. Section 21 requires that no licensed insurer shall undertake activities other than that of insurance, except for the purposes of, and in connection with, the insurance business which it is licensed to carry on. An example of an activity which might be in breach of Section 21 is trading in financial instruments for speculative purposes, as this would not necessarily be considered to be investment activity in connection with or for the purposes of the company's insurance business.
 - the requirements in Section 83 of the Ordinance concerning the application of assets held in the life fund.
 - the requirements in Section 64B of the Ordinance concerning the suitability and spread of assets covering insurance liabilities, the need for appropriate diversification of assets and the need for close matching of linked assets and liabilities. (For example, depending on a company's financial position, gearing of a fund might easily be inconsistent with the obligations under Section 64B).
 - the requirements of the Insurance Companies (Valuation of Assets and Liabilities) Regulations 1996 concerning currency matching and localisation of assets.
 - any prudential guidance on any of the above topics issued or endorsed by the Commissioner.

10. Overall responsibility for the determination, implementation and monitoring of such a strategy rests with the Board of Directors.
11. In the case of a company carrying on long-term business, the Board should be aware of the responsibilities of the appointed actuary, in particular the duty to advise about an appropriate investment policy for the long term fund of a life insurer, and should ensure that the actuary is in a position to discharge those responsibilities.

Controls Over Exposures

12. Notwithstanding the admissibility limits in Schedule 1 to the Insurance Companies (Valuation of Assets and Liabilities) Regulations 1996, appropriate procedures should be in place for assessing the credit-worthiness of counterparties to whom the insurer is significantly exposed, and for setting lower internal limits than those in Schedule 1 where prudence dictates such a course. This applies, in particular, to potential exposure to reinsurers which is exempt from the Schedule 1 limits.
13. Notwithstanding the admissibility limits in Schedule 1 to the Regulations, appropriate procedures should be in place for setting prudent limits for the company's aggregate exposure to certain categories of asset. Such limits should take account of the requirements of Section 64B(1) of the Ordinance concerning the suitability of assets to cover insurance liabilities. They may take account of the level of the company's free assets, bearing in mind the possibility that such assets might in future be needed to cover insurance liabilities or the prescribed minimum margin of solvency.
14. Systems should be in place to allow the company to monitor its aggregate exposure to different categories of asset (paying particular attention to the different kinds of instrument under which exposure can arise), or to particular counterparties, relative to the limits set under the procedures described in paragraphs 12 and 13 above. The question of monitoring exposure to counterparties is developed in Annex A.
15. Systems should be in place to ensure that the assets of linked long-term funds of the company comply fully with Section 64B(2) and (3) of the Ordinance and with Regulation 40 of the Insurance Companies (Valuation of Assets and Liabilities) Regulations 1996.

The Investment Managers

16. The investment strategy should be reflected in clear terms of reference from the company to its investment managers who must be qualified and competent to carry out their assigned task, and whose remuneration package should be consonant with that strategy. The work of the managers should be monitored sufficiently closely to ensure that the company's strategy is being followed and that the systems mentioned above are effective. These points apply equally where an external manager is used for this purpose, where a separate legal entity within the insurance group is used (in either of which cases we would expect there to be a formal agreement between the two parties), or where the managers are internal. The issues are developed in Annex B.

Use Of Derivatives And Other Complex Investment Instruments

17. Management should ensure that controls over derivatives and other complex investment instruments have been implemented and are adequate to ensure that risks are properly assessed, regularly reviewed in the light of changing



market conditions and experience and consistent with the overall investment strategy. This area is enlarged on in Annex C.

Resources Allocated

18. Resources allocated to the tasks mentioned above should be appropriate, both in quantity and quality, for ensuring that the controls are effective at all times. This applies particularly in respect of the matters covered in paragraph 17.

Reports To The Board

19. In order to satisfy themselves that investment activity is carried out in accordance with the approved strategy and that adequate controls are in place, the Board of Directors will need to receive reports at an appropriate frequency with appropriate details as to the investment activities and controls.

Further Guidance

20. If you would like to discuss any of the matters raised above further, please contact the Insurance Supervisor on (350) 40283.

ANNEX A - Monitoring Of Aggregate Exposures

1. The Insurance Companies (Valuation of Assets and Liabilities) Regulations 1996 introduce the concept of aggregate exposure which is used as the amount against which the asset admissibility limits are applied. The limits are expressed as percentages of the Long Term or General Business Amounts, as appropriate. A detailed explanation of how these limits work can be found in Insurance Guidance Note No. 4. These limits represent maximum amounts which can be valued for solvency purposes; it will often be prudent for companies to set internally lower limits in order to comply with the general provisions on suitability of assets.
2. The new admissibility limits also introduce some aggregate limits e.g. there is a maximum limit of 10% excluding bank deposits (20% if deposits are included) of the Long Term or General Business Amounts which can be with any one counterparty or connected company from whatever source. In other words, "exposure" needs to be accumulated for:
 - all types of investment and other activities of the insurance company, e.g. all derivatives transactions, stock lending, bank deposits and other loans.
 - all operations of the insurance company, i.e. including branches. Exposure through subsidiary operations will also need to be accumulated within these limits where the assets of that subsidiary are valued on a "look through" basis. The explicit limits do not, however, apply to exposures generated through a parent or fellow subsidiary of the insurance company. Where the insurance company has diverse investment operations, then it may be appropriate to set "local" limits which, even if aggregated, would still fall within the permitted overall limits.
 - all dealings with the counterparty concerned, or any of its connected companies. A connected company in this context means any parent, subsidiary or fellow subsidiary of the counterparty concerned. For example, the limits would apply to combined dealings with Bank XYZ or with the derivatives trading subsidiary of that bank, together with the stockbroker balances with the broker owned by Bank XYZ's parent company. Insurers will therefore need to find out if any of their counterparties are connected and make sure that they are kept informed of any changes to the status of existing counterparties.
3. When assessing what the counterparty exposure is, only the amounts actually owing to the insurer need to be considered. For example derivatives transactions with brokers would be based on the market value of the contract, not the nominal value (which would be a much greater amount). Exposure could be further reduced by any margin arrangement. Aggregate exposure will normally initially be assessed on a gross basis (i.e. total amounts due to the insurer from the counterparty concerned). But we believe that application of generally accepted accounting practice may allow this to be reduced by amounts which the insurer owes the counterparty where there is a legal right of off-set.

Credit Exposure To Reinsurers

4. Although there are no quantitative limits in the regulations for reinsurance recoveries, companies should still have regard to their accumulated credit exposure to individual reinsurers. (In this context, exposure normally means debts due from the reinsurer plus anticipated recoveries on outstanding claims and IBNR. No account should be taken of amounts which are offset by



subsequent retrocessions). We would not consider a company to be soundly and prudently managed if it controlled its investment activities but, in the context of its total assets, had unacceptable levels of exposure to any one reinsurer. In this context, exposure would not only relate to the amounts for which credit has been taken in the company accounts, but would also take into account how the insurer was planning to meet its future liabilities. The assessment of what is an “acceptable” level of exposure to a particular reinsurer may take into account the security provided by any collateral arrangements such as letters of credit and deposits-back, as well as the credit worthiness of the reinsurer itself.

Insurance Groups

5. As noted above, the detailed admissibility limits generally apply at an insurance company level rather than for an insurance group as a whole. For its own prudential management reasons, group management may still wish to ensure that the basic principles apply across the group. Monitoring of exposure to individual counterparties will obviously be more difficult for groups but it could be possible to use the “local limits” approach suggested for branches.

ANNEX B - Controls Over Investment Managers

1. Where investment management is contracted out to a third party, the directors of the insurance company must nevertheless satisfy themselves that the appropriate controls are in place and are effective. This applies not only where the entire function is contracted out, but also where only a specialist element such as derivatives trading is carried out by a third party. The directors should ensure in the latter cases, in particular, that the effects of their own in-house activities are considered in conjunction with the contracted out activities when monitoring aggregate exposures to certain types of investment and/or counterparty. (It should be noted that the counterparty limits apply to the insurer's share of investments only, not to the entire portfolio of the investment manager).
2. In determining what are appropriate and effective controls, we would normally expect the insurance company, as a minimum, to focus on the following areas:
 - There should be a clear contract which sets out the parameters in which the investment manager may operate. It is unlikely that the managers' "standard" contract (even if it is approved by their own regulators) will be sufficient for this purpose. We would expect tailoring to be made to reflect the legislative constraints (e.g. admissibility limits, permitted links), any investment limits set by the insurer and, more generally, the insurer's specific circumstances. For example, "to invest in whatever the manager considers appropriate" is not good enough. Apart from any specific limits, the parameters need to strike an appropriate balance between risk and reward, taking due account of the nature of the company's insurance liabilities and, as appropriate, the interests, or reasonable expectations, of its policyholders.
 - The extent of reporting by the managers should be sufficient to enable the insurance company to assess whether or not actual operations are in line with the company's strategy, and in particular meets the risk/reward criteria set. Reporting should also provide sufficient information for the insurer to check how close it is to relevant asset admissibility limits (or to its own internal limits, if lower).
 - Additional, more detailed, monitoring of the managers' operations may be necessary in certain circumstances. However, where the manager is subject to its own regulatory regime there is unlikely to be any need for the insurer to carry out its own "audits" of the managers' operating controls. This does not mean that the insurer can absolve itself of all responsibility of ensuring that the manager's systems and controls are adequate, merely that credit can be taken for certain areas, such as operation of client money rules, which are subject to audit by other parties.
 - If the investment manager is to hold funds on behalf of the insurance company, or to be a counterparty to certain investment transactions, then the extent of capitalisation and form of regulation of the manager will need to be taken into account. These considerations will need to be regularly reassessed, e.g. manager A may be suitable if placing £10m of business but not for £100m. Similar considerations will also apply where the insurance company alters its investment strategy and moves into newer forms of investment activity for which the existing investment manager has little or no experience.



3. It should also be noted that any new corporate manager appointed by the company will be required to be notified to the Commissioner. Third party investment managers would, therefore, normally be notifiable in future and will need to pass the appropriate “fit and proper” tests.

ANNEX C - Controls Over Derivatives

1. The directors of an insurance company should take all steps which are reasonable (taking account of the nature and scale of use of derivatives) to satisfy themselves that management:
 - fully understands the nature of derivatives trading being undertaken by the organisation and the related risks and, where relevant, is suitably qualified and competent to manage the range and type of transactions being undertaken and understand the nature of the exposures (including both counterparty and market risk) which their use will create;
 - has documented clearly the objectives and policies for the use of derivatives and will monitor their use (including the carrying out of compliance audits) to ensure that it is in line with those objectives and policies. Management should define the instruments that may be dealt in sufficiently closely to ensure that new types of instrument are not dealt in without due prior consideration. They should also define any associated limits on exposures or volumes that are considered appropriate;
 - has given due regard, in particular, to uncovered transactions (which may only be undertaken in relation to assets which do not match technical provisions) in the context of the above controls, so that in no circumstances is the minimum margin of solvency endangered nor, in the case of companies carrying on long-term business, are policyholders' reasonable expectations adversely affected. Systems are needed which are adequate to prevent exposure to unacceptable exceptionally volatile risks, and to monitor transactions on a frequency commensurate with volatility and risk (in general terms). The systems should trigger a strategy to hedge or close out a transaction whenever adverse movements or events threaten a significant worsening of the company's solvency position;
 - has ensured that those who have responsibility for the control of derivatives investment, are sufficiently independent of the day-to-day operators to ensure effective control;
 - is capable of analysing and monitoring the risk of all transactions undertaken by the organisation individually and in aggregate (including interest rate risk, foreign exchange risk, fraud, error, unauthorised access to confidential information and other operational risks);
 - has ensured that the systems cope adequately with volumes and volatility of transactions undertaken. In particular, attention and funding to the front office systems should not be to the detriment of the accounting systems;
 - is provided regularly with statistics and information (appropriately summarised) on the trading volumes of derivatives by type of product including regular reports of all off-balance sheet transactions, contingencies and commitments;
 - is satisfied that sufficient control procedures relevant to derivative products have been put in place, including independent agreement and reconciliation of positions, independent checking of prices, agreement of managers' profits to accounting profit, appropriate authorisation where dealing limits have been exceeded, etc;



- has tested adequately and approved valuation models which are used to value open positions and derivative instruments, and that amendments to their programmes are controlled. Such models should include an appropriate test of the robustness of the portfolio to stress in changing investment conditions.
2. In satisfying themselves on the above points, the Directors collectively will need sufficient expertise to understand the important issues. Fuller guidance on the use of derivatives in insurance funds, and on the reporting of the use of derivatives will be issued shortly.