ICP 15 Investment

The supervisor establishes requirements for solvency purposes on the investment activities of insurers in order to address the risks faced by insurers.

Introductory Guidance

15.0.1 This ICP does not directly apply to non-insurance entities (regulated or unregulated) within an insurance group but it does apply to insurance legal entities and insurance groups with regard to the risks posed to them by non-insurance entities.

Basis for Establishing Regulatory Investment Requirements

15.1 The supervisor establishes requirements that are applicable to the investment activities of the insurer.

Adoption date: 29.12.2010

15.1.1 The nature of insurance business necessitates the establishment of technical provisions and loss-absorbing capital. This, in turn necessitates the investment in and holding of assets sufficient to cover technical provisions and capital requirements. The quality and characteristics of an insurer's asset portfolio and the interplay and interdependence between the insurer's assets and its liabilities are central to an assessment of an insurer's solvency position, and hence, are important aspects to be addressed by the supervisor and for an insurer to manage.

15.1.2 There are various reasons for insurers to make investments (e.g. capital appreciation, hedging or cash flow expectation) and there is a wide variety of assets that insurers may invest in, with the risk profiles of different investments varying widely. Some assets, such as equities and property are subject to unpredictable short term price movements. Other assets such as corporate and government bonds have fixed or defined income, with uncertainty related to the price at which these assets can be sold before

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related to the price at which these assets can be sold before maturity and the extent to which the counterparty is able to make fixed income payments and repay the principal. Unless restricted, derivatives may be used for speculative or hedging purposes and some may be subject to wide variations in their value and involve unlimited commitments.

Adoption date: 30.12.2010

15.1.3 Financial requirements are not sufficient by themselves to ensure solvency and should be complemented with appropriate quantitative and/or qualitative requirements limiting/regulating the investment risks that are taken by the insurer. This guards against the possibility that the regulatory capital requirements and the insurer's own risk and solvency assessments do not fully cover the risks inherent in those activities.

15.1.4 In establishing regulatory investment requirements, factors considered may include:

- the overall quality of risk management and governance frameworks in the insurance industry in the jurisdiction;
- the way in which the quality of capital resources is addressed by the supervisor, including whether or not quantitative requirements are applied to the composition of capital resources;
- the comprehensiveness and transparency of disclosure frameworks in the jurisdiction and the ability for markets to exercise sufficient scrutiny and impose market discipline;
- the development of relevant investment and capital markets locally and internationally and the range of available financial instruments;
- the cost of compliance, the impact on innovation and the effect on the efficiency of industry practices keeping in mind that the protection of policyholders is the main focus of prudential regulation;
- noting that insurers compete with other financial services institutions, the requirements on the investment activities of other financial services entities, including banks; and

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- the level of prudence and risk-sensitivity of the regulatory solvency requirements and the risks that they cover.

15.1.5 Regulatory investment requirements may take many forms and may influence the investment strategies of the insurer. Requirements may be rules-based, setting out specific rules or restrictions on the investment activities of the insurer. For example, the requirements may set out quantitative limits on the asset types in which the insurer can invest. Alternatively, requirements may be principles-based, such that there is no specific restriction on the asset strategy taken by the insurer, as long as defined principles are met.

15.1.6 Regulatory investment requirements may be a combination of rules-based and principles-based requirements, setting out some specific rules or restrictions and some principles with which the insurer’s investment strategy should comply. Broadly, regulatory investment requirements should provide the basis and incentives for the implementation of effective risk management by the insurer.

15.1.7 Rules-based requirements may be used to prohibit or limit specific classes of investment. Such requirements may be used, for example, for classes that have very volatile payouts, such as commodities, certain derivatives, asset classes where the counterparty is below a certain credit rating, unsecured loans, unquoted shares and exposures to closely related companies. Rules may also be defined to restrict exposure to any single counterparty, group, or homogeneous risk group (such as industry and geographical area) to, for example, a defined percentage of the total assets or capital base. Such rules or restrictions may either be applied directly to the investments or lead to charges to or deductions from available capital which act as a disincentive to investment in risky assets or high concentrations in particular assets rather than as a prohibition.

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15.1.8 Rules-based requirements may be relatively easy to enforce by supervisors, as there is limited scope for different interpretations of the rules. Similarly, they may be more readily explainable to a court when seeking enforcement of supervisory action. A further advantage of rules-based requirements is that the supervisor is able to prohibit or deter the insurer from investing in an asset class that it believes is not appropriate for it to hold.

15.1.9 However, rules-based regulatory requirements may stifle innovation and may restrain the insurer from holding the assets that it believes are most appropriate for meeting its financial objectives. For example, an insurer may want to use derivatives in a hedging strategy to protect it from adverse market movements, but derivatives may be on the list of restricted assets. This may result in an ineffective risk management process, or prevent the insurer from developing innovative contracts to meet policyholder needs. Also, since the nature of business and structure of liabilities differ among insurance companies, a uniform rule-based regulatory requirement on investment, which is applicable to all insurers, may discourage insurers from developing their own risk management.

15.1.10 One advantage of principles-based requirements is that there is more flexibility for the insurer in its choice of particular investments and therefore to follow an investment strategy that it believes is the most appropriate to its risk profile, risk tolerance and overall financial objectives. The insurer will be able to select and follow the investment strategy to best manage its investment risks. Another advantage of principle-based requirements is that they may not need to be revised so frequently in response to innovations in the investment market. A potential disadvantage of a solely principles-based investment regime is that it may allow certain innovative investments which prove to be riskier than originally assessed. It may also be more difficult for the supervisor to take enforcement actions as principles-based investment requirements admit some scope for differences in interpretation.

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15.1.11 The supervisor should establish investment requirements having regard to such requirements applied in other, non-insurance, financial sectors. It is important that requirements are consistent to the extent possible, in order to prevent groups from transferring assets between the entities in the group to take advantage of regulatory arbitrage. Consistency of regulation between sectors assists in maintaining a level playing field and enhances fairness. However, such requirements should take into account the differences in risk profiles and risk management between sectors.

Additional Guidance for Insurance Groups

15.1.12 For insurance groups, the supervisor should specify how investments should be aggregated for the purposes of regulatory investment requirements that apply to the group and consider appropriate restrictions on intra-group transactions, for example, to limit contagion or reputational risk. Issues to be considered may include exposures to related counterparties and the exposures arising from investments in subsidiaries and interests over which the insurer has some influence. In stress situations there will tend to be greater restrictions on movements and realisation of investments within the group. The regulatory regime may therefore require contractual evidence of the ability to access assets for solvency purposes before allowing their inclusion for group purposes.

15.2 The supervisor is open and transparent as to the regulatory investment requirements that apply and is explicit about the objectives of those requirements.

15.2.1 Openness and transparency of the supervisory investment requirements are required to facilitate its effective operation. The supervisor should be explicit as to the objectives of setting regulatory investment requirements. This is particularly important with regard to the consistency of such requirements with other building blocks of the regulatory solvency assessment of the insurer, such as the valuation of assets and liabilities, the calculation of regulatory capital requirements and the determination of available capital resources.

Additional Guidance for Insurance Groups

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15.2.2 A supervisor for insurance groups should be explicit as to the requirements that apply both on a group-wide basis as well as to insurance legal entities within the group and should address issues specific to groups, such as requirements for liquidity, transferability of assets and fungibility of capital within the group.

15.2.3 In respect of group solvency, transparency allows appropriate comparisons with other solvency requirements. The openness and transparency of the regulatory investment requirements in the jurisdictions in which an insurance group operates also facilitates the effective individual solvency assessment of insurers which are members of the group and its corresponding group-wide solvency assessment.

Regulatory Investment Requirements Regarding Asset Portfolio

15.3 The regulatory investment requirements address at a minimum, the

- **Security;**
- **Liquidity; and**
- **Diversification;**

of an insurer's portfolio of investments as a whole.

15.3.1 The supervisor should require the insurer to invest assets in such a manner that, for the portfolio as a whole:

- assets are sufficiently secure;
- payments to policyholders or creditors are able to be made as they fall due (liquidity);
- assets are held in the appropriate location for their availability; and
- assets are sufficiently diversified.

15.3.2 Insurance legal entities should be able to demonstrate that they meet the regulatory investment requirements as well as enterprise risk management requirements.

Additional Guidance for Insurance Groups

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15.3.3 In addition to meeting the qualitative and quantitative investment requirements at an insurance legal entity level, the insurance group should monitor[4] investment risk exposures on an aggregate basis for the group as a whole.

[4] Monitoring in this context does not imply that the assets are managed centrally but that, at a minimum, the asset risks are aggregated and considered, and acted on, appropriately.

15.3.4 The investment requirements should consider cases where losses from investments made by entities of an insurance group have the ability to weaken another entity or the group as a whole through intra-group investments (for example if there is explicit or implicit support from another entity).

15.3.5 The assets of an entity within an insurance group may include participations or investments in another entity within the same group. Appropriate investment requirements should apply to such investments or participations which have particular regard to their lack of liquidity. Relatively small holdings in another insurance group entity which does not give the investor control over the investee may, for example, be subject to the same requirements that apply to investments in entities external to the group. On the other hand, for larger holdings which give the investor control or significant influence over the investee, consideration should be given to aggregating the assets of the investee with those of the investor for the purposes of applying investment requirements. This is done so that adequate security, liquidity and diversification are maintained and that the investor, using its control over the investee, ensures the investee's investment activities are consistent with its own investment policy.

Security

15.3.6 The supervisor requires that the insurer's investments are sufficiently secure both individually and for the portfolio as a whole. A sufficient degree of security of investments is essential so that obligations to policyholders can be met. The security of an investment is related to the protection of its value and to the preservation of its economic substance. Hence it may be necessary to establish regulatory investment requirements to restrict the insurer's selection of, and/or exposure to, investments that have low security or whose security is difficult to assess reliably.

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15.3.7 The security of an investment is affected by the risk of default of a counterparty with which the investment is made, as well as the risk that it will lose its value (including currency risk, discussed in Guidance 15.4.1). Security is also affected by the safekeeping, custodianship or trusteeship of its investments. The insurer should ensure that its overall portfolio is sufficiently secure.

15.3.8 Where external credit ratings of the investment are available, these may assist the insurer in determining the security of the counterparty and the associated risk of default. However, the insurer should be aware of the limits of using credit ratings and, where appropriate, conduct its own due diligence to assess the counterparty credit risk exposure. The supervisor may also establish requirements on the appropriate use of credit ratings by the insurer to ensure a sufficient degree of security of investments.

15.3.9 To assess the security of its investments, it is important that the insurer is capable of assessing the nature, scale and complexity of the associated risks. This may be difficult in cases where there is a lack of transparency as to the underlying risk profile of an investment. This may be the case for indirect investments through a collective investment fund or for investments in more complex financial instruments such as structured asset products. When an insurer invests in some markets, there may also be a lack of transparency or clarity in respect of the market, regulatory and legal systems that apply and the degree of protection that they provide.

15.3.10 For those assets which are lacking in transparency, the risk profile should be carefully analysed by the insurer. The insurer should look through to the underlying exposure of the investment as far as possible as well as considering the additional risks introduced by and inherent in the investment structure. For example, additional legal risks may arise if investments are located outside of the insurer’s operating jurisdictions. Potential obligations to make future payments under the assets should be identified and adequately covered.

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15.3.11 The security of derivative products should be evaluated by taking into account the assets underlying the derivative, as well as the security of the counterparty providing the derivative, the purpose for which the derivative is held and the cover (such as collateral) the insurer has for exposures under the derivative contract. In some cases, counterparties may provide collateral to improve security by giving the insurer the right to the collateral if the counterparty fails. Similarly, the security of investments may be improved by guarantees from more secure third parties.

15.3.12 Some investments that are not themselves derivatives may embed a derivative, thereby having an effect on the insurer corresponding to the derivative itself. Some commitments may be transacted through Special Purpose Entities (SPEs) which may be "off-balance sheet" in some jurisdictions. Such commitments which are similar to derivatives have similar security issues and the regulatory investment requirements should address these commitments in a consistent manner.

15.3.13 When an insurer lends securities, it must consider both the risk inherent in the counterparty to which the securities are lent and the risk of the securities themselves. The insurer should seek to ensure that securities lending transactions are appropriately collateralised (with suitably frequent updating) and should recognise that lending a security does not mitigate the risk it poses to the insurer, even if doing so removes the security from the balance sheet. Care should be taken by the insurer when investing the collateral it holds that it will continue to cover the lending under adverse market conditions and that it will be returnable in the required form when due.

Additional Guidance on Security for Insurance Groups

15.3.14 The supervisor should make appropriate allowance for the possibility of an aggregation of exposures in an insurance group compounding security issues that may be relatively less important when considered at individual entity level. Correspondingly, the supervisor should guard against a group investing in assets that are not secure and which may then be distributed around the group to avoid investment restrictions, by requiring appropriate consolidated disclosure.

Liquidity

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15.3.15 The insurer is required to pay benefits to the policyholder when the benefits become due. In order to do so, the insurer needs to have available assets which can be used to generate cash when it needs to do so. This includes disposal of assets for an amount (in the relevant currency) equal to the value it ascribes to that asset in addition to cash from income on assets that the insurer retains.

15.3.16 The ability of the insurer to remain in a liquid position may be adversely impacted if, for example, the insurer pledges or hypothecates its assets, it experiences an unexpectedly large claim, there is an event resulting in many claims or a derivative needs to be serviced. A large cash outflow may impact the liquidity of the insurer leaving it with less liquid assets to make other policyholder payments.

15.3.17 The ability to realise or liquidate an investment at any point in time is important. For example, where an investment is made in a closed fund, it would usually not be possible to resell the interest in the fund. This may also impede the security of the investment in terms of its ability to settle obligations towards policyholders. Similar considerations would need to be given for property used by the insurer which might be hard to liquidate without disrupting its operations.

Additional Guidance on Liquidity for Insurance Groups

15.3.18 The legal and practical impediments to cross-border movement of assets should also receive due regard. It is unlikely that available capital, however liquid within a jurisdiction, will be perfectly mobile across jurisdictional borders, particularly in a crisis. Therefore insurers and home and host supervisors should have due regard to the nature of the potential legal and practical impediments to cross-border transfer of assets as well as any potential effect those impediments might have, particularly in a winding up.

15.3.19 Group issues are also relevant when managing liquidity risk both in terms of the availability of additional liquidity and the possible need to provide liquidity support to other parts of the group.

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15.3.20 Very often, the entities within a group engage in intra-group transactions (e.g. swaps, inter-company loans) in order to offset risks that exist within different parts of the group, or so that more mature businesses may support growing businesses within the group. Such transactions should be done using appropriate transfer pricing based on current market conditions so that there is appropriate recognition of the impact of these transactions for each of the entities involved and the group as a whole.

15.3.21 Liquidity of assets and fungibility of capital are especially important if the group relies on diversification between entities without each entity being fully capitalised on a stand-alone basis (where the supervisor allows this scenario).

Diversification

15.3.22 Diversification and pooling of risks is central to the functioning of insurance business. To mitigate the risk of adverse financial events, it is important that the insurer ensures that its overall investment portfolio is adequately diversified and that its asset and counterparty exposures are kept to prudent levels.

15.3.23 It is useful to draw a distinction between diversification within a risk category and diversification between risk categories. Diversification within a risk category occurs where risks of the same type are pooled (e.g. shares relating to different companies). It is related to the statistical property that the volatility of the average of independent, identically distributed random variables decreases as the number of variables increases. Diversification between risk categories is achieved through pooling different types of risk. For example, where the insurer combines two asset portfolios whose performances are not fully correlated, the exposure to the aggregated risks will generally be lower than the sum of the exposures to the risks in the individual portfolios.

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15.3.24 With respect to its investment portfolio, the insurer should ensure that it is diversified both within as well as between risk categories taking into account the nature of the liabilities. Diversification between investment risk categories could, for example, be achieved through spreading the investments across different classes of assets and different markets. To achieve diversification within a risk category, the insurer needs to ensure that with respect to a given type of risk the investments are sufficiently uncorrelated so that – through pooling of individual assets – there is a sufficient degree of diversification of the portfolio as a whole.

15.3.25 To ensure that its investment portfolio is adequately diversified, the insurer should avoid excessive reliance on any specific asset, issuer, counterparty, group, or market and, in general, any excessive concentration or accumulation of risk in the portfolio as a whole. As an example the insurer might consider its asset concentration by type of investment product, by geographical dispersion, or by credit rating. The insurer should also ensure that its aggregate exposure to related entities is considered and that different types of exposure to the same entity/group are also considered e.g. equity investment in a reinsurer which is also providing its reinsurance cover.

Additional Guidance on Diversification for Insurance Groups

15.3.26 Monitoring investments on a group-wide basis is more likely to make management aware of issues (e.g. asset concentrations) that could be overlooked if only the individual legal entities are monitored. Groups that are unaware of their global exposures could end up with an inappropriate level of exposure to certain investments, creating financial difficulties within the group if the value or liquidity of these investments decreases.

Regulatory Investment Requirements Relating to the Nature of the Liabilities

15.4 The supervisor requires the insurer to invest in a manner that is appropriate to the nature of its liabilities.

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15.4.1 The assets that are held to cover policyholder liabilities and those covering regulatory capital requirements should be invested in a manner which is appropriate to the nature of the liabilities as the insurer will need to use the proceeds of its investments to pay the policyholders and other creditors, as and when the payments to them fall due. The insurer's investment strategies should take into account the extent to which the cash flows from its investments match the liability cash flows in both timing and amount and how this changes in varying conditions. In this context, the insurer should specifically consider investment guarantees and embedded options that are contained in its policies. It should also consider the currency or currencies of its liabilities and the extent to which they are matched by the currencies of the assets. To the extent that assets and liabilities are not well matched, movements in financial variables (e.g. interest rates, market values and exchange rates) could affect the value of the assets and the liabilities differently and result in an adverse economic impact for the insurer.

15.4.2 This requirement to take into account the characteristics of the liabilities does not necessarily place a requirement on the insurer to employ an investment strategy which matches the assets and the liabilities as closely as possible.

15.4.3 As liability cash flows are often uncertain, or there are not always assets with appropriate cash flow characteristics, the insurer is usually not able to adopt a completely matched position. The insurer may also wish to adopt a mismatched position deliberately to optimise the return on its business. In such circumstances, the supervisor may require the insurer to hold additional technical provisions and/or capital to cover the mismatching risk. The regulatory investment requirements may also constrain an insurer's ability to mismatch its assets and liabilities as the extent of mismatching should not expose policyholders to risks that cannot be effectively managed by the insurer.

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15.4.4 However, close matching of assets and liabilities is usually possible and should be considered as a potential requirement in the case of unit-linked or universal life policies where there is a direct link between policyholder benefits and investment funds or indices. It may not otherwise be possible for the mismatching risk to be covered effectively by capital. Where a regime requires assets to be closely matched to such liabilities, other restrictions on investments may be appropriate to contain the investment fund risk being borne directly by policyholders.

15.4.5 The insurer should manage conflicts of interest (e.g. between the insurer's corporate objectives and disclosed insurance policy objectives) to ensure assets are invested appropriately. For with-profits liabilities, an insurer should hold an appropriate mix of assets to meet policyholders' reasonable expectations.

Additional Guidance for Insurance Groups

15.4.6 Investments that back liabilities including those covering regulatory capital requirements within one of a group's legal entities should be tailored to the characteristics of the liabilities and the needs of the legal entity and not subject to undue influence from the wider objectives of the group.

Regulatory Investment Requirements Regarding Risk Assessability

15.5 The supervisor requires the insurer to invest only in assets whose risks it can properly assess and manage.

15.5.1 The insurer should ensure that its investments, including those in collective investment funds, are sufficiently transparent and should limit its investments to those where the associated risks of the asset can be properly managed by the insurer i.e. where the insurer can identify, measure, monitor, control and report those risks and appropriately take them into account in its own risk and solvency assessment.

15.5.2 The insurer should understand all of the risks involved sufficiently well before any such investments are undertaken. Such an understanding is necessary in order to assess how material the risk from a proposed investment is to an insurer. Assessments of risks should take into account the maximum loss possible in a transaction, including losses that may occur in situations where assets or derivatives become liabilities for the insurer.

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15.5.3 15.5.3 Where the insurer is able to look through the structure of the investments to the underlying assets, the insurer should consider the risk characteristics of the underlying assets and how this affects the risk characteristics of the investments itself. However, where look through is not possible, appropriate techniques should be developed to assess the risks associated with the investment, e.g. by assessing the investment manager of an investment fund.

15.5.4 Investments which are not admitted to trading on a regulated financial market should be kept to prudent levels as the assessment of their risks may be subjective. This is particularly relevant where standardised approaches to determining regulatory capital requirements are used, since such standardised approaches will often be designed to be not unduly complex and thus feasible in practice for all insurers, whilst delivering capital requirements which reasonably reflect the overall risk to which the insurer is exposed. Moreover, by its very nature a standardised approach may not be able to fully and appropriately reflect the risk profile of the investment portfolio of each individual insurer.

Additional Guidance for Insurance Groups

15.5.5 Investments held by entities within a group are sometimes managed centrally, with the entities relying on expertise provided by the group head office or specialist central unit. Such arrangements may be acceptable if the investment management unit has the requisite knowledge and skills to assess and manage the risks of these investments and manages the investments with due regard to the needs of the entity in addition to the group as a whole.

Regulatory Investment Requirements Relating to Specific Financial Instruments

15.6 The supervisor establishes quantitative and qualitative requirements, where appropriate, on the use of more complex and less transparent classes of assets and investment in markets or instruments that are subject to less governance or regulation.

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15.6.1 Complex investments pose additional risks in that large, sudden and/or unexpected losses can occur. For example, off-balance sheet vehicles have led to losses arising from implicit obligations of support, structured credit products have lost value when correlations between assets increased in stress environments, and unhedged derivatives have produced large liabilities arising from extreme low-probability market events.

15.6.2 Similarly, additional considerations need to be given for assets in which investment is permitted by the regime (because the risk is generally sufficiently assessable) but which are less transparent compared to other investments. Other assets could be less well governed in terms of the systems and controls in place for managing them or the market regulation that applies to them. Such assets may present operational risks that may arise in adverse conditions which are difficult to assess reliably. In terms of market regulation, investments in an unregulated market or a market that is subject to less regulation such as a professional securities market need to be given special consideration.

15.6.3 Supervisors should therefore establish quantitative and qualitative requirements or restrictions on such investments including those described below. As an example, where appropriate the regulatory investment requirements might include the pre-approval of an insurer's derivative investment plan e.g. a dynamic hedging program. That pre-approval procedure could require that the insurer describe its controls over the derivative investment process and the testing of the process before it is used in a live environment.

15.6.4 The investments described below do not represent an exhaustive list and regulatory investment requirements should be flexible (or sufficiently broad) to take account of the changing environment. The solvency position and the sophistication of an insurer should also be considered. The amount of available capital an insurer has could provide additional flexibility to the supervisor in particular cases.

Off-balance Sheet Structures

15.6.5 The supervisor should consider whether investments in off-balance sheet structures should be permitted under the regulatory investment regime or if the investment was set up in order to circumvent any regulatory investment requirements.

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15.6.6 SPEs are generally set up for a specific purpose to meet specific payments to investors, who have accepted the risk profile of their payments based on the cash flows underlying the SPE. The investment strategy for the SPE may need to be more restrictive than the strategy for the insurer, which may choose to make more risky investments if it has adequate free assets.

15.6.7 The investment strategy for the structure may be different from the investment strategy for the insurer, as there may be a different appetite to take on different investment risks. However, the investment strategy adopted by the off-balance sheet structure may have an impact on the ability of the insurer to make payments to the policyholders, especially if the structure is in a stressed position.

Investments in Structured Credit Products

15.6.8 It may also be the case that the insurer invests in securities or other financial instruments which have been “repackaged” by an SPE and which may originate from other financial institutions (including banks or insurers). Examples of such instruments are asset backed securities (ABS), credit linked notes (CLN) or insurance linked securities (ILS). In these cases, it may be very difficult for the insurer to assess the risk inherent in the investment (and in particular the risk profile of the underlying reference instruments which in some cases may be of particularly poor quality e.g. sub-prime mortgages). Where the originator is another insurer, the investment may also carry insurance related risks (such as non-life catastrophe risks in the case of a non-life catastrophe bond securitisation) which may not be transparent to the insurer or else difficult to assess.

15.6.9 In order to prevent that the insurer is exposed to an undue level of risk in such cases, the supervisor may consider establishing qualitative or quantitative requirements which may relate directly to the insurer investing in such assets, or which may relate to the originator of the “repackaged” instrument.

15.6.10 Such requirements may recognise that some structured credit products are higher risk than others and consider, for example:

- the treatment of such investment in other financial sectors;
- the extent to which the originator has retained an

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interest in a proportion of the risk being distributed to the market;

- the definition and soundness of criteria applied by the originator in extending the original credit and in diversifying its credit portfolio;
- the transparency of the underlying instruments; and
- the procedures the insurer has in place to monitor exposures to securitisations, including consideration of securitisation tranches, and reporting them to the insurer's Board and Senior Management and supervisor.

Restrictions or prohibition may be applied to investments in structured products where appropriate conditions are not satisfied.

Use of Derivatives and Similar Commitments

15.6.11 A derivative is a financial asset or liability whose value depends on (or is derived from) other assets, liabilities or indices (the "underlying asset"). Derivatives are financial contracts and include a wide assortment of instruments, such as forwards, futures, options, warrants and swaps. Similar commitments can be embedded in hybrid instruments that are not themselves derivatives (e.g. a bond whose maturity value is tied to an equity index is a hybrid instrument that contains a derivative). An insurer choosing to engage in derivative activities should clearly define its objectives, ensuring that these are consistent with any legislative restrictions.

15.6.12 Derivatives, used appropriately, can be useful tools in the management of portfolio risk of insurers and in efficient portfolio management. In monitoring the activities of insurers involved in derivatives, the supervisor satisfies itself that the insurer has the ability to recognise, measure and prudently manage the risks associated with their use. The supervisor should obtain sufficient information on the insurer's policies and procedures on the use of derivatives and may request information on the purpose for which particular derivatives are to be used and the rationale for undertaking particular transactions.

This should be read in conjunction with the overall ICP material, including the Introduction. The hierarchy of principle statements, standards and guidance is explained in the Introduction.

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15.6.13 Given the nature of insurance operations, derivatives should preferably be used as a risk management mechanism rather than for speculative investment. Supervisors may restrict the use of derivatives (particularly derivatives that involve the possibility of unlimited commitments) to the reduction of investment risk or efficient portfolio management. This means that where derivatives are used it is required that this is for the purpose of reducing risk and costs or generating additional capital or income with an acceptable level of risk. Restrictions may also be applied to require the suitability of derivative counterparties, the cover the insurer has to meet any obligations it has under the derivative, the tradability of the derivative and, in the case of over-the-counter derivatives, the ability to value it and to close it out at that value when needed. Derivatives should be considered in the context of a prudent overall asset/liability management strategy. This should also apply to financial instruments that have the economic effect of derivatives.

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