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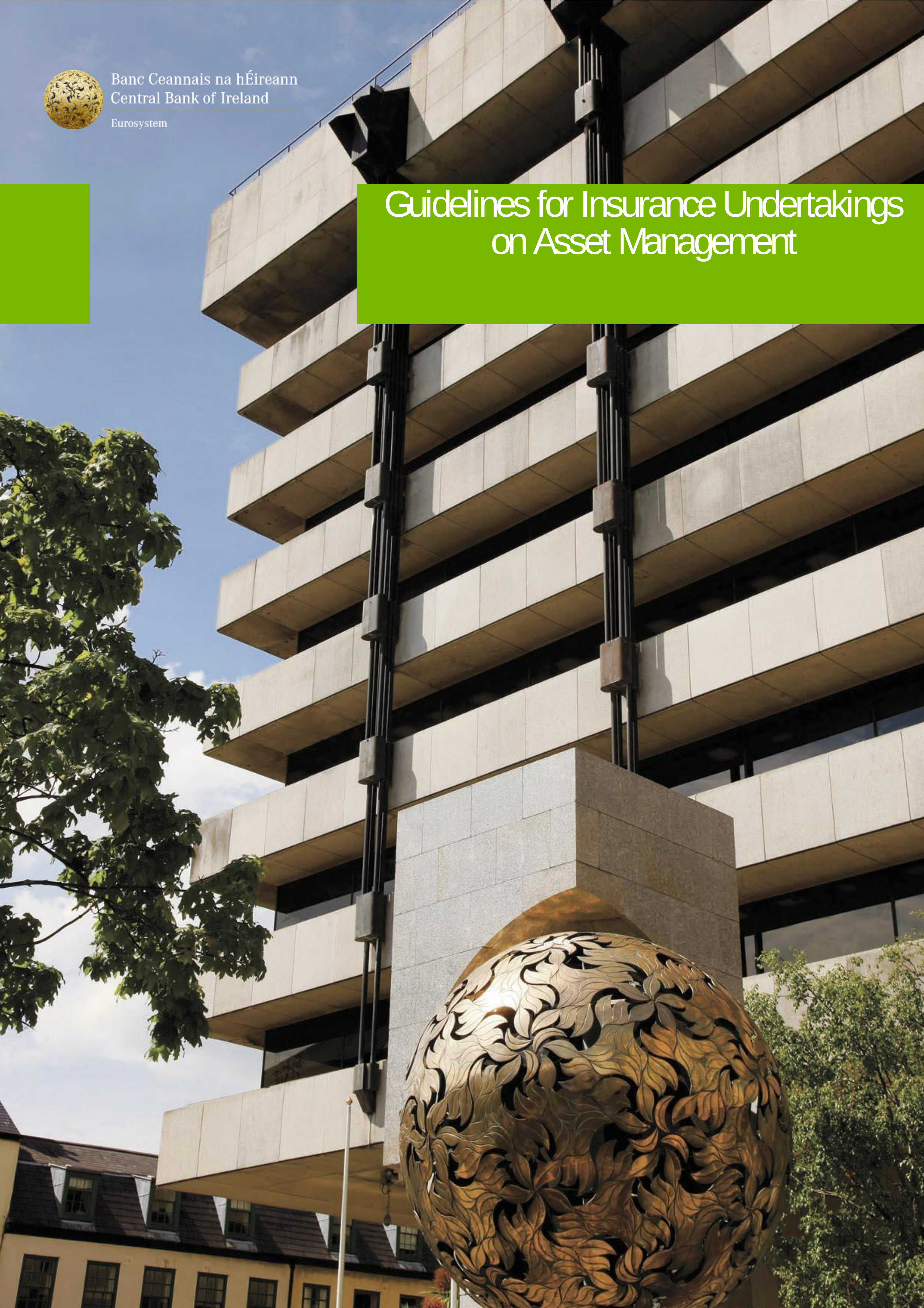
Guidelines for Insurance Undertakings on Asset Management



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Context

This document is a reformatted version of the original guidance document issued by the Department of Enterprise, Trade & Employment in July 2001. No fundamental changes have been made to the original guidance.

1. General

The safekeeping and the liquidity of assets are not explicitly addressed in the insurance regulations. In attempting to rectify the situation it was considered preferable to adopt a broad approach and to provide overarching guidance for undertakings on asset management rather than address specific instances or examples. Therefore, the following guidance is based on the 'Supervisory Standard on Asset Management by Insurance Companies' and 'Standard on Asset-Liability Management' as issued by the International Association of Insurance Supervisors (available at www.iaisweb.org). In an effort to provide a comprehensive view of the subject, the following information has been drawn up with reference to current regulations and previously issued guidance notes. The implementation of the guidance needs to be tailored to the particular circumstances of each undertaking. For example, the Central Bank of Ireland does not expect that smaller undertakings, such as captive undertakings, will implement the guidance in the same manner as a general insurance undertaking or life undertaking. The issue of supervisory guidance for captive insurance undertakings is addressed in a separate guidance note entitled 'Guidance on Prudential Supervision applicable to Captive Insurers'. However, it is considered vital that all undertakings (including captives) address the issues contained in this document and formalize appropriate internal policies and procedures in relation to their asset management. All insurance undertakings are required to submit a Directors' Compliance Certificate with their Annual Returns. This Certificate will state, inter alia that the undertaking's practice in relation to the management of assets comply with legislation and this guidance.

2. Introduction

Insurance undertakings must invest in and hold assets to adequately cover both their technical provisions and their required solvency margin. In order to ensure that an undertaking can meet its contractual liabilities to policyholders, such assets must be managed in a sound and prudent manner. The undertaking must take account of the profile of its liabilities and, indeed, the complete risk-return profile. The risk-return profile should result from an integrated view on product policy, underwriting policy, reinsurance policy, investment policy and solvency level policy. The liabilities profile of an undertaking with respect to term, and the predictability of the size and timing of claims payments, may differ significantly according to the nature of the insurance business conducted. It follows that the need to maintain a high degree of liquidity within the asset portfolio will differ between insurance undertakings.

The objective of this guidance is to describe the essential elements of a sound asset management system and reporting framework across the full range of investment activities. This guidance does not purport to be an interpretation of insurance legislation. This guidance should be used in conjunction with the relevant legislation. Given the wide variation in the nature of undertakings, it is acknowledged that the extent of the application of the practices described in this document may differ according to the size and structure of an undertaking and the type of business it conducts. However, the basic principles of Board of Directors' responsibility, the need for a sound investment policy, segregation of duties and control will be applicable to all insurance undertakings.

2.1 Asset/Liability Management
A key driver of the asset strategy adopted by an undertaking is the profile of its liabilities. An undertaking must ensure that it holds sufficient assets of appropriate nature, term and liquidity to enable it to meet liabilities as they become due. As such a number of things are required:

- Detailed analysis and management of the asset/liability relationship
- The ongoing development and review of investment policies and procedures
- Adequate management of investment risks as they relate to solvency
- Testing the resilience of the asset portfolio to a range of market scenarios and investment conditions and the impact these scenarios may have on the undertakings solvency position

2.2 The Investment Process

Depending upon the nature of their liabilities, insurers will typically hold, in varying proportions, four main types of financial assets either directly, via other investment vehicles (e.g. UCITS [Undertakings for Collective Investments in Transferable Securities]), or through third party investment managers:

a. Bonds and other fixed income instruments
b. Equities and equity type investments
c. Debts, deposits and other rights
d. Property

The holding of a given asset portfolio carries a range of investment-related risks to technical provisions and solvency. As such, undertakings are required to monitor, measure, report and control these risks. The main risks are:

a. Market risk (adverse movements in, for example, stocks, bonds and exchange rates)
b. Credit risk (counterparty failure)
c. Liquidity risk (inability to unwind a position at or near market price)
d. Operational risk (system/internal control failure)
e. Legal risk

The composition of an asset portfolio at any given moment should be the product of a well-structured investment process. This process is regarded as a cycle that can be characterized by the following steps:

a. Formulation and development of a strategic and tactical investment policy
b. Implementation of the investment policy, in a suitably equipped investment organisation, and on the basis of a clear and precise investment mandate(s)
c. Control, measurement and analysis of the investment results achieved and the risks taken
d. Feedback to the appropriate level of authority on the points outlined above (a, b and c)

The insurance regulations impose restraints on the investment policies and procedures of undertakings by placing restrictions on the type of, and extent to which, certain asset classes may be used to cover technical provisions. In addition there are specific requirements on the matching of assets and liabilities vis-à-vis currency. Nevertheless, undertakings should develop and operate overall asset management strategies, which take account of the need to ensure the existence of:

a. The definition of a strategic investment policy by the Board of Directors, based on an assessment of the risks incurred by the undertaking and its risk appetite;

b. On-going Board and senior management oversight of, and clear management accountability for, investment activities;

c. Comprehensive, accurate and flexible systems which allow the identification, measurement and assessment of investment risks, and the aggregation of those risks at various levels, for example for any separate portfolios held, for the undertaking and, as appropriate, at group level, at any given time. Such systems will vary in each undertaking, but should be:

- sufficiently robust to reflect the scale of the risks and the investment activity undertaken;
- capable of accurately capturing and measuring all significant risks in a timely manner;
- understood by all relevant personnel at all levels of the insurer;

d. Key control structures, such as the segregation of duties, approvals, verifications and reconciliations;

e. Adequate procedures for the measurement and assessment of investment performance;

f. Adequate and timely communication of information on investment activities between all levels within the undertaking;

g. Internal procedures to review the appropriateness of the investment policies and procedures in place;

h. Rigorous and effective audit procedures and monitoring activities to identify and report weaknesses in investment controls and compliance.

i. Procedures to identify and control the dependence on and vulnerability of the insurer to key personnel and systems.

3. Regulations and guidelines for their interpretation

Annex III of the European Communities (Non-Life Insurance) Framework Regulations 1994 (S.I. No. 359 0f 1994), and Annex V of the European Communities (Life Assurance) Framework Regulations 1994 (S.I. No. 360 0f 1994) outline the standards for the valuation of assets appropriate to compliance with statutory solvency requirements, based essentially on realisable value.

Annex III, together with Schedule 2 (3rd Non-Life Directive); and, Annex V, together with Schedule 7 (3rd Life Directive), are intended to encourage a prudent spread of assets without imposing undue restraints upon investment selection and management which might be disadvantageous to the undertaking, or its policyholders. Regulations of this kind can be expected to achieve such a purpose only in a fairly broad manner. The fact that investments are within the permissible limits is no guarantee as to their suitability. The undertakings' senior management are ultimately responsible for the investment decisions taken. Sound asset allocation policy, commercial profitability and the policyholders' interests all directly influence these decisions. It remains the duty of management, at all times, to satisfy themselves and the Central Bank as to the suitability of an undertakings investment portfolio.

Schedules 2 (Non-Life Regulations) & 7 (Life Regulations) specify maximum percentage limits, on both individual and aggregate bases, on the admissibility of different categories of assets for representing technical reserves. The purpose of these limitations is to restrict the amounts acceptable as cover for technical reserves where there is considered to be too great a concentration of investment, either individually or in aggregate, in a particular asset or type of asset. It is important to note that the holding of amounts in excess of these limits is not prohibited but excess amounts must be left out of account for the purpose of covering technical reserves. However, such "excess" assets may be readmitted for solvency purposes.

Where, in the case of a particular asset, a valuation rule is not explicitly given in the Regulations a nil value must be assigned to it. Accordingly, such items such as advance commission and goodwill must be excluded.

Linked Assets

Life insurance linked assets are not required to be valued in accordance with Annex V (Life Regulations). Linked assets, including approved derivative instruments held in linked funds, are required to be valued in accordance with generally accepted accounting concepts, bases and policies appropriate for life undertakings and in practice would be valued on the same basis as that adopted for the calculation of the corresponding property linked benefits. The definition of linked assets refers only to life assurance business assets which are identified in an undertaking's records as being assets by reference to the value of which property linked benefits are to be determined - it should be noted that the definition of property linked benefits does not comprehend benefits linked to an index of the value of assets not so held and identified with the consequence that such index linked assets are treated as non-linked assets.

4. Definition of the Investment Policy and Procedures

4.1 Board of Directors

The Board of Directors should be responsible for the formulation and approval of the strategic investment policy, taking account of the analysis of the asset/liability relationship, the insurer's overall risk tolerance, its long-term risk-return requirements, its liquidity requirements and its solvency position.

The investment policy, which should be communicated to all staff involved in investment activities, should in principle address the following main elements:

a. The determination of the strategic asset allocation, that is, the long-term asset-mix over the main investment categories
b. The establishment of limits for the allocation of assets by geographical area, markets, sectors, counterparties and currency
c. The formulation of an overall policy on the selection of individual securities and other investment titles
d. The adoption of passive or more active investment management in relation to each level of decision making
e. In the case of active management, definition of the scope for investment flexibility, usually through the setting of quantitative asset exposure limits
f. The extent to which the holding of some types of assets is ruled out or restricted where, for example, the disposal of the asset could be difficult due to the illiquidity of the market or where independent (i.e. external) verification of pricing is not available
g. An overall policy on the use of financial derivatives as part of the general portfolio management process or of structured products that have the economic effect of derivatives
h. The framework of accountability for all asset transactions

The Board of Directors are also responsible for establishing policies on related issues of a more operational nature, including:

a. The choice between internal or external investment management and in the case of the latter, the criteria for selection of the manager(s). Also, in the case of external management, a choice usually needs to be made between having a segregated (discretionary) portfolio managed, participation in a collective/pooled fund or other indirect investment vehicles;
b. The selection and use of brokers;
c. The nature of custodial arrangements;
d. The methodology and frequency of the performance measurement and analysis.

The Board of Directors must authorise implementation of the overall investment policy. The Board of Directors will, however, always retain ultimate responsibility for the undertaking's investment policy and procedures, regardless of the extent to which associated activities and functions are delegated or, indeed, outsourced.

As part of the development of the asset management strategy the Board of Directors must also ensure that adequate reporting and internal control systems are in place, designed to monitor that assets are being managed in accordance with the investment policy and mandate(s), and legal and regulatory requirements. The Board of Directors must ensure that:

a. They receive regular information, including feedback from the undertaking's risk management function, on asset exposures, and the associated risks, in a form which is understood by them and which permits them to make an informed judgment as to the level of risk on a mark-to-market basis
b. The systems provide accurate and timely information on asset risk exposure and are capable of responding to ad hoc requests
c. The internal controls include an adequate segregation of the functions responsible for measuring, monitoring and controlling investment activities from those conducting day-to-day asset transactions
d. Remuneration policies are structured to avoid potential incentives for unauthorised risk taking

Where external asset managers are used, the Board of Directors must ensure that the undertaking is in a position to monitor the performance of the external managers against Board approved policies and procedures. External managers should be engaged under a contract that, inter alia, sets out the policies, procedures and quantitative limits of the investment mandate. The undertaking must retain appropriate expertise and ensure that, under the terms of the contract, it regularly receives sufficient information to evaluate the compliance of the external asset manager with the investment mandate.

The Board of Directors should collectively have sufficient expertise to understand the important issues related to investment policy and should ensure that all individuals conducting and monitoring investment activities have sufficient levels of knowledge and experience.
At least annually, the Board of Directors should review the adequacy of its overall investment policy in the light of the undertakings activities, and its overall risk tolerance, long-term risk-return requirements and solvency position.

4.2 Senior Management

The responsibility for the preparation of a written investment mandate(s) setting out the operational policies and procedures for implementing the overall investment policy established by the Board of Directors will frequently be delegated to senior management. The precise content of the mandate will be different for each undertaking but the level of detail should be consistent with the nature of the current regulatory constraint and complexity and volume of investment activity, and should specify as appropriate:

a. The investment objective, and the relevant limits for asset allocation, and the currency allocation and policy; any relevant investment benchmarks should also be specified;
b. An exhaustive list of permissible investments and, as appropriate, derivative instruments, including details of any restrictions as to markets (e.g. only securities listed at specified stock exchanges), minimum rating requirements or minimum market capitalisation, minimum sizes of issues to be invested in, diversification limits

and related quantitative or qualitative limits;

c. Details of who is authorised to undertake asset transactions;

d. Any other restrictions with which portfolio managers have to comply, for example maximum risk limits within the overall investment policy (or in terms of limits on the duration of the portfolio in the case of a fixed-income portfolio), authorised counterparties;

e. The agreed form and frequency of reporting and accountability.

Supporting internal management procedures should be documented and include:

a. Procedures for seeking approval for the usage of new types of investment instruments; (the desirability of retaining the flexibility to utilise new investment instruments should be balanced with the need to identify the risks inherent in them and ensure that they will be subject to adequate controls before approval is given for their acquisition. The principles for measuring such risk, and the methods of accounting for the new investments should be clarified in detail prior to approval being given for their acquisition)

b. Procedures for the selection and approval of new counterparties and brokers;

c. Procedures covering front office, back office, measurement of compliance with quantitative limits, control and reporting;

d. Details of the action that will be taken by senior management in cases of non-compliance;

e. Valuation procedures for risk management purposes;

f. Identification of who should be responsible for the valuation. Individuals whom are independent of those responsible for trade execution should carry out valuations. If this is not possible, valuations should be independently checked or audited on a timely basis.

Accounting and taxation rules should also be taken into consideration in developing the operational policies and procedures.

Senior management should ensure that all individuals conducting, monitoring and controlling investment activities are suitably qualified and have appropriate levels of knowledge and experience.

At least annually, senior management should review the adequacy of its written operational procedures and allocated resources in the light of the undertakings activities and market conditions.

5. Monitoring and Control

5.1 Risk Management Function

Undertakings should be capable of identifying, monitoring, measuring, reporting and controlling the risks connected with investment activities. This process should be performed by a risk management function with responsibility for:

- Monitoring compliance with the approved investment policy;
- Formally noting and promptly reporting breaches;
- Reviewing asset risk management activity and results over the past period;
- Reviewing the asset/liability and liquidity position

The risk management function should also assess the appropriateness of the asset allocation limits. To do this, regular resilience testing should be conducted for a wide range of market scenarios and changing investment and operating conditions. Once an undertaking has identified those situations to which it is most at risk, it should ensure that it feeds back appropriate amendments to the policies and procedures defined in its investment mandate in order to manage those risk situations effectively.

The risk management function should regularly report to appropriate levels of senior management and, as appropriate, to the Board of Directors. The reports should provide aggregate information as well as sufficient detail to enable management to assess the sensitivity of the undertaking to changes in market conditions and other risk factors. The frequency of reporting should provide these individuals with adequate information to judge the changing nature of the insurer's asset profile, the risks that stem from it and the consequences for the undertakings' solvency.

5.2 Internal Controls

Adequate systems of internal control must be present to ensure that investment activities are properly supervised and that transactions have been entered into only in accordance with the insurer's approved policies and procedures. Internal control procedures should be documented. The extent and nature of internal controls adopted by each undertaking will be different, but procedures to be considered should include:

a. Reconciliations between front office and back office and accounting systems
b. Procedures to ensure that any restrictions on the power of all parties to enter into any particular asset transaction are observed. This will require close and regular communication with those responsible for compliance, legal and documentation issues in the undertaking
c. Procedures to ensure all parties to the asset transaction agree with the terms of the deal. Procedures for promptly sending, receiving and matching confirmations should be independent of the front office function
d. Procedures to ensure that formal documentation is completed promptly
e. Procedures to ensure reconciliation of positions reported by brokers
f. Procedures to ensure that positions are properly settled and reported, and that late payments or late receipts are identified
g. Procedures to ensure asset transactions are carried out in conformity with prevailing market terms and conditions

h. Procedures to ensure that all authority and dealing limits are not exceeded and all breaches can be immediately identified

i. Procedures to ensure the independent checking of rates or prices: the systems should not solely rely on dealers for rate/price information

The functions responsible for measuring, monitoring, settling and controlling asset transactions should be distinct from the front office functions. These functions should be adequately resourced.

Regular and timely reports of investment activity should be produced which describe the undertaking's exposure in clearly understandable terms and include quantitative and qualitative information. The reports should, in principle, be produced on a daily basis for senior management purposes; less frequent reporting may be acceptable depending on the nature and extent of asset transactions. Upward reporting by senior management is recommended on at least a monthly basis. Reports should at least include the following areas:

a. Details of, and commentary on, investment activity in the period and the relevant period end position
b. Details of positions by asset type
c. An analysis of credit exposures by counterparty
d. Details of any regulatory or internal limits breached in the period and the actions taken thereto
e. Planned future activity
f. Details of the relative position of assets and liabilities

5.3 Audit

Auditors are expected to evaluate the independence and overall effectiveness of the undertaking's asset management functions. In this regard, they should thoroughly evaluate the effectiveness of the internal controls relevant to measuring, reporting and limiting risks. Auditors should evaluate compliance with risk limits and the reliability and timeliness of information reported to senior management and the Board of Directors.

Auditors should periodically review the undertaking's asset portfolio and written investment policies and procedures to ensure compliance with regulatory obligations.

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