

**BERMUDA MONETARY AUTHORITY**

**INSURANCE DEPARTMENT**

**GUIDANCE NOTE #15**

**INVESTMENTS**

**MARCH 2005**

## **GUIDANCE NOTE: INVESTMENTS**

### **Introduction**

- 1 Insurers must be prudently managed. The prime responsibility for the sound and prudent management of an insurer rests with the board of the insurer. An investment portfolio carries a range of investment-related risks that might affect the insurer's solvency. Insurers must manage their investments in a sound and prudent manner that is consistent with the risk profile of the company. This note sets out guidance on an insurer's investment activities.
- 2 The Bermuda Monetary Authority (the "Authority") recognizes the need for clarity as to the scope and implementation of the provisions of the Insurance Act and related regulations ("the Act")<sup>1</sup> if the regulatory system is to command the confidence of both insurers and policyholders. It seeks, therefore, to ensure that those operating in Bermuda have a good understanding of the nature of the requirements and of the Authority's approach in implementing the Act.
- 3 While the Authority aims to provide clarity as to its approach, this guidance note cannot be exhaustive. The Authority will do its best through this and other guidance notes to set out information about its regulatory approach and expectations regarding an insurer's investment management activity.
- 4 Other guidance issued by the Authority may contain additional information on investments or related matters.<sup>2</sup>
- 5 The Authority's guidance is of a general application and seeks to take account of the wide diversity of institutions that may be licensed under the Act. There is likely to be a need for the guidance to be revised and developed over time. Material changes in the guidance will be published, generally through the issue of revised versions.

---

<sup>1</sup> The insurance legislation is comprised of the Insurance Act 1978 (as amended by the Insurance Amendment Acts, 1981, 1983, 1985, 1995, 1998 and 2001) and the regulations promulgated under that Act (the "Regulations"). The Regulations are the Insurance Accounts Regulations 1980 (as amended by The Insurance Accounts Amendment Regulations 1981, 1985 and 1989) and the Insurance Returns and Solvency Regulations 1980 (as amended by The Insurance Returns and Solvency Amendment Regulations 1981, 1985 and 1989). References herein to the "Act" are to the Insurance Act 1978 (as amended) and the Regulations.

<sup>2</sup> An insurer's approach to the management of its investments directly impacts on an insurer's corporate governance. The Authority has issued separate guidance notes on a number of subject matters relating to corporate governance and the decision making process, including corporate governance, risk management and internal controls, and insurance activities.

- 6 For references in these Guidance Notes with respect to the changes in legislation contained in the Insurance Amendment Act 2004 insurers must take immediate steps to ensure they are in compliance with the Act. In relation to other matters contained in the Guidance Notes, the Authority encourages insurers to come into compliance as soon as possible and, in any event, not later than 31<sup>st</sup> December 2005 or a later date as may be agreed with the Authority in a particular case.

### **Application**

- 7 This guidance applies to all insurers registered under the Act.
- 8 In seeking to ensure that the objectives of this guidance are met, having regard to the size, nature, complexity and risk profile of the business of the registered insurer, the board must exercise its judgement in determining the nature and scope of the investment management activity and the related procedures and standards that are necessary. It is the responsibility of the board to determine which specific provisions of this guidance should be applied.
- 9 As part of its supervisory process, the Authority will look for indications that, overall, processes or procedures for investment management are in place, that they are appropriate to the individual insurer, and that they are operating effectively. The Authority will formulate its judgment on the effectiveness of an insurer's approach to investment management based on a variety of indicators. The degree of applicability and weighting of individual elements in this guidance will depend on the size, nature, complexity and risk profile of each insurer. For example, the Authority recognizes that insurers which only insure or reinsure the risks of their owners and are part of the same organization may pose less risk to the public than other insurers or reinsurers, and that it may be appropriate for the investment management policies and procedures for these entities to be less complex than for other insurers.<sup>3</sup>

### **Prudent person**

- 10 Insurers must manage their investments in a sound and prudent manner that is consistent with the risk profile of the company. Insurers need to identify, measure, report and control the main risks. The board of directors of an insurer should establish, and the insurer adhere to investment policies, standards and procedures that a reasonable and prudent person would apply in respect of a portfolio of investments to avoid undue risk of loss and obtain a reasonable return.

---

<sup>3</sup> As stated in the IAIS Principles on Minimum Requirements for Supervision of Reinsurers approved in October 2002 "*where captives only insure the risks of their owners and are part of the same organization they may not pose the same risk to the financial system and separate regulations may be established recognizing this reduced risk.*" This approach is also consistent with international best practices as described by the International Association of Insurance Supervisors, which recognize that the principles adopted in a jurisdiction should take into account the domestic context and industry.

## **Role of the board**

- 11 The Authority expects that the board of directors will be ultimately responsible for the oversight of investment management, regardless of the extent to which associated activities and functions are delegated or outsourced. Key staff involved with investment activities should have the appropriate levels of skills, experience and integrity.

## **Valuation of investments**

- 12 Insurers are required to value investments in accordance with the Act.

## **Investment strategy**

- 13 Insurers should have an overall strategic investment policy for both on-balance sheet and off-balance sheet items, approved and reviewed annually by the board of directors that addresses the following main elements:
- the risk profile of the insurer;
  - the determination of the strategic asset allocation, that is, the long-term asset mix over the main investment categories;
  - the establishment of limits for the allocation of assets, for example, by types of instruments, geographical area, markets, sectors, counterparties, investment grades and currency;
  - the extent to which the holding of some types of investments are restricted or disallowed, for example illiquid or volatile assets or derivatives;
  - the conditions under which the insurer can pledge or lend assets;
  - an overall policy on the use of financial derivatives and structured products that have the economic effect of derivatives;
  - clear accountability for all investment transactions and associated risks, and
  - contingency plans to mitigate the effects of deteriorating investment market conditions.
- 14 The Board of Directors should review the adequacy of the overall investment policy, at least annually, considering the company's activities, its overall risk tolerance, its long-term requirements and its solvency position.

## **Monitoring and Control**

- 15 The insurer's insurance risk management systems should cover the risks associated with investment activities that might affect the coverage of technical provisions and/or solvency margins (capital).<sup>4</sup> The main risks include market risk, credit risk, currency risk, liquidity risk and failure in the safe-keeping of assets (including the risk of inadequate custodial agreements).
- 16 Insurers should have in place adequate systems of internal controls to ensure the safeguarding of assets, that investment activities are properly supervised and adherence to the investment policy, as well as in compliance with legal, accounting, and regulatory requirements.<sup>5</sup> Insurers should have in place procedures to ensure the timely identification of internal control weaknesses and operating system deficiencies.

## **Asset/Liability Matching**

- 17 Insurers should have in place effective procedures for monitoring and managing their asset/liability position to ensure that their investment activities and asset positions are appropriate to settle their liabilities when they come due.

## **Derivatives and similar commitments**

- 18 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, warrants and swaps. These features can be embedded in hybrid instruments. Derivatives have inherent risks that should be managed properly.
- 19 An insurer should have comprehensive systems in place, forming part of its wider investment risk management systems, for the identification, control, valuation and reporting of derivatives and other assets and/or liabilities that the insurer is required to disclose in its financial reporting.
- 20 The insurer should have in place an appropriate policy for the use of derivatives, formulated, approved and regularly reviewed for adequacy by the directors. The policy should be consistent with the insurer's activities, its overall strategic investment policy, its asset/liability management strategy and its risk tolerance.

---

<sup>4</sup> The Authority has issued a separate guidance note for risk management and internal controls. This should be referred for additional information about the Authority's regulatory approach and expectations regarding these matters.

<sup>5</sup> The Authority has issued a separate guidance note for risk management and internal controls. This should be referred for additional information about the Authority's regulatory approach and expectations regarding these matters.

21 The policy should address:

- the purposes for which derivatives may be used;
- the establishment of appropriately structured exposure limits, taking into account the uncertainty caused by market, credit, liquidity, cash flow, operational and legal risk;
- the extent to which the holding of some types of derivative is restricted or not authorised; for example, where the potential exposure cannot be reliably measured, the closing out or disposal of the derivative could be difficult due to its lack of marketability (as may be the case with over-the-counter instruments) or the illiquidity of the market, or where independent (i.e. external) verification of pricing is not available;
- the responsibilities of the directors and management with regard to the use of derivatives, and the necessary qualifications and experience required of those directors and staff managing and dealing with such transactions; and
- a framework of accountability for derivative functions, so that such activities are properly overseen and regularly reviewed by the board and, as applicable, by internal and external audit.

22 The insurer should have risk management and internal control systems in place, covering the risks from derivatives to ensure that:

- the risks arising from all derivative transactions undertaken by the insurer can be analysed and monitored individually and in aggregate, and monitored and managed in an integrated manner with similar risks arising from non-derivatives activities so that exposures can be regularly assessed on an aggregated basis; and
- derivatives activities are properly overseen and that transactions have been entered into only in accordance with the insurer's approved policies and procedures, and legal and regulatory requirements. These controls ensure appropriate segregation between those who measure, monitor, settle and control derivatives and those who initiate transactions.

23 Insurers should have:

- in place personnel with appropriate skills to vet models and to price the instruments used, and that pricing follows market convention. These functions should also be separate from any responsibilities for investment decisions and related trading; and

- the appropriate capability to verify pricing independently where the use of ‘over-the-counter’ derivatives is permitted under the insurer’s policy.

### **Minimum Margin of Solvency**

- 24 Insurers are required to maintain assets in accordance with the Act such that the insurer meets the minimum margin of solvency for general business and/or minimum margin of solvency for long-term business, as applicable [at all times]. [IARSR 10, 12]

### **Minimum Liquidity Ratio for General Business**

- 25 Insurers who write general business are required to maintain assets in accordance with the Act such that the insurer meets the minimum liquidity ratio for general business [at all times]. [IARSR 11]

### **Value of the Insurer’s Assets at Year End**

- 26 Where an insurer writes general business, the insurer must state on the general business solvency certificate whether in the opinion of the two directors signing the certificate the value of the insurer’s assets at the end of the year was in the aggregate at least equal to the statutory balance sheet asset value. [IRSR 8(1)(d)]
- 27 Where an insurer writes long-term business, the insurer must state on the long-term business solvency certificate whether in the opinion of the two directors signing the certificate the value of the insurer’s assets at the end of the year was in the aggregate at least equal to the statutory balance sheet asset value. [IRSR 9(1)(c)]

End of guidance note.

***If you have questions on this or other guidance from the Insurance Department please email [info@bma.bm](mailto:info@bma.bm) . Please put “Insurance Guidance” in the title of your email.***