Prudential Supervision Manual

Insurance Companies

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Part II

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II.1 Guidelines on Asset Management

1. Preamble

7KLV JXLGHOLQH FRQWDLQLQJ ³EHVW SUDFWLFHV´ ZLWK based on the supervisory standard on Asset Management by Insurance Companies issued by the International Association of Insurance Supervisors (IAIS). The objective of this guideline is to describe the essential elements of a sound asset management system and reporting framework across the full range of investment activities. Given the wide variation in the nature of companies, it is acknowledged that the extent of the application of the practices described in this guideline by any given insurer may differ according to the size and structure of an insurance company and the type of business it conducts. However, the basic principles of sound corporate governance, the need for an investment policy, segregation of duties and control are applicable to all insurance companies.

2. Introduction

2.1 Asset Liability Management

A key driver of the asset strategy adopted by an insurer will be its liabilities profile, and the need to ensure that it holds sufficient assets of appropriate nature, term and liquidity to enable it to meet the liabilities as they become due. Detailed analysis and management of this asset/liability relationship will therefore be a pre-requisite to the development and review of investment policies and procedures, which seek to ensure that the insurer adequately manages the investment-related risks to its solvency.

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, 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 which insurers need to monitor, measure, report and control.

The main risks are market risk (adverse movements in, for example, stocks, bonds and exchange rates), credit risk (counterparty failure), liquidity risk (inability to unwind a position at or near market price), operational risk (system/internal control failure), and legal risk.
The actual composition of an asset portfolio at any given moment should be the product of a well-structured investment process itself, which for the purposes of this standard is regarded as a circular movement 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 organization, and on the basis of a clear and precise investment mandate(s);
c. Control, measurement and analysis of the investment results which have been achieved and the risks taken;
d. Feedback to the appropriate level of authority on points a, b and c.

The insurers 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 in consultation with senior-management, based on an assessment of the risks incurred by the company 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 that allow the identification, measurement and assessment of investment risks, and the aggregation of those risks at various levels, and for any given time.
d. Key control structures, such as the segregation of duties, approvals, verifications, 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 insurance company;
g. Internal procedures to review the appropriateness of the investment policies and procedures in place;
h. 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.

The following sections further develop the above principles, recognizing that less formalized structures and procedures than those described herein may be applicable depending on the size and nature of the business of an individual insurer.

3. Definition of the Investment Policy and Procedures

3.1 Supervisory Board

The Board in consultation with senior management is responsible for the designing of the strategic investment policy, taking account of the analysis of the asset/liability relati RQVKLS WKH LQVXUHU¶V RYHUDOO ULVN WROHUDQFH L term risk-return requirements, its liquidity requirements and its solvency position.

The Board should authorize senior management to implement the overall established investment policy. The Board should, however, retain ultimate responsibility for the FRPSDQ\¶V LQYHVWPHQW SROLF\ DQG SURFHGXUHV UHJDUG activities and functions are delegated or, outsourced.

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

a. 7KH\ UHFHLYH UHJXODU LQIRUPDWLRQ LQFOXGLQJ I 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 judgement 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;

Where external asset managers are used, the Board must ensure that senior management 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 insurer 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 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 in consultation with senior management should review the DGHTXDF\ RI LWV RYHUDOO LQYHVWPHQW SROLF\ LQ WKH activities, and its overall risk tolerance, long-term risk-return requirements and solvency position.

3.2 Senior Management

Senior management should be responsible for the preparation of written operational policies and procedures for implanting the overall investment policy established by the Board. The precise content of these policies and procedures will be different for each insurance company but the level of detail should be consistent with the nature of any regulatory constraint and complexity and volume of investment activity, and should specify as approciate:

a. The investment objective and 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;

Senior management should also be responsible for establishing policies on related issues of a more operational nature, including:

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

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 utilize 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 which will be taken by senior management in cases of noncompliance;

e. Valuation procedures for risk management purposes;

f. Identification of who should be responsible for the valuation. Valuations should be carried out by individuals independent of those responsible for trade execution or, if this is not possible, valuations should be independently checked or audited on a timely basis.

Accounting and taxation rules should be taken into consideration in developing the above 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 li J K W R I W K H L Q V X U D Q F H F R I activities and market conditions.

4. Monitoring and Control

4.1 Risk Management Function

Insurers 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:

a. Monitoring compliance with the approved investment policy;
b. Formally noting and promptly reporting breaches;

c. Reviewing asset risk management activity and results over the past period;
d. Reviewing the asset/liability and liquidity position.

The risk management function should also assess at least on an annual basis the appropriateness of the asset allocation limits. The risk management function should also regularly report to appropriate levels of senior management and, as appropriate, to the Board. The reports should provide aggregate information as well as sufficient detail to enable management to assess the sensitivity of the company to changes in market conditions and other risk factors. The frequency of reporting should provide these indi YLGXDOV ZLWK DGHTXDWH LQIRUPDWLRQ WR MXGJH WKH SURILOH WKH ULVNV WKDW VWHP IURP LW DQG WKH FRQVH

4.2 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 ZLWK WKH LQVXUHU¶V DSSURYHG SROLFLHV DQG SURFHGXU be documented. The extent and nature of internal controls adopted by each insurer 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 insurer;

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 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 FRPSDQ\¶V H[SRVXUH LQ FOHDUO\ XQGHUVWDQGDEOH WHU
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 quarterly 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.

II.2 Appointment of an external auditor

Directive on the appointment of an external auditor by virtue of article 10 in conjunction with article 15a of the State Ordinance on the Supervision of the Insurance Business (AB 2000 no. 82) (SOSIB) for insurance companies licensed by the Centrale Bank van Aruba (the CBA).

1. Introduction

It is important that supervisors obtain the information they need to properly form an opinion on the financial strength of the operations of each insurance company. This information is obtained, amongst others, from the financial reports that are filed, supported by information obtained through communication with the external auditor. As such, supervisors have a clear interest in ensuring that external audits performed are acceptable and that an adequate relationship between them and the insurance companies' external auditors exists, essentially based on the principles and guidance papers formulated by the International Association of Insurance Supervisors. In this respect, high standards of auditing are indispensable. As such, the audit performed should be carried out by external auditors who:

- are properly licensed and in good standing;
- have relevant professional experience and competence;
- are subject to a quality assurance program;
- are independent in fact and in appearance;
- are objective and impartial; and
- comply with all ethical requirements.

Pursuant to article 1 of the SOSIB, an external auditor is: 'a person who is not employed by the company or institution, being a "registeraccountant" or an "accountant-administratieconsulent" registered pursuant to article 36, paragraph 2, item i, of the Dutch Law on the accounting profession (Stb. 2012, 680)'.

2. Directive

Any appointment of or change in external auditor needs the CBA's prior written approval. In order to assess the intended appointment or change, the institution concerned and the external auditor are required to complete the "Questionnaire External Auditor" (Annex 2). Reference is also made to the Guidance notes associated with the Questionnaire External Auditor.

In case of a change of external auditor, the CBA should be informed on the reason(s) for the intended change.