Appendix 5

In this annex underlining indicates new text and striking through indicates deleted text.

The DFSA Rulebook

Prudential – Insurance Business Module

(PIN)

2 MANAGEMENT AND CONTROL OF RISK

2.1 Introduction

2.1.1 This chapter applies to every Insurer.

Guidance

1. All Authorised Firms are subject to the systems and controls provisions of GEN chapter 5. This chapter expands on the relevant requirements of GEN as those provisions apply in the context of an Insurer.

2. App2 contains guidance for Insurers in respect of specific areas of risk management that are of particular relevance to Insurers.

2.2 Risk management

2.2.1 An Insurer's risk management systems must:

(a) be appropriate to the size, business mix and complexity of the Insurer's operations; ~~and~~

(b) address all material risks, financial and non-financial, to which the Insurer is likely to be exposed~~.~~;

(c) describe the relationships between the Insurer's risk tolerance limits, its capital requirements, economic capital and the processes and methods for monitoring risk; and

(d) be supported by adequate risk management policies and procedures which explain the risks covered, the measurement approaches used, and the key assumptions made.

2.2.2 The risk management systems maintained by an Insurer must include:

(a) a written risk management strategy approved by senior management, which in the opinion of senior management addresses all material risks to which the Insurer is likely to be exposed;

(b) risk management policies and procedures that in the opinion of senior management are adequate to identify, assess, mitigate, control, monitor and report on the material risks to which the Insurer is exposed; and

(c) clearly identified managerial responsibilities and controls, designed to ensure that the policies and procedures established for risk management are adhered to at all times.

2.2.3 Subject to Rule 2.2.4, where an Insurer is a member of a Group, the Insurer must take reasonable actions to ensure that the Group as a whole complies with the requirements of Rule 2.2.1 and 2.2.2 as though the Group as a whole were an Insurer.

2.2.4 Rule 2.2.3 does not apply in respect of a Group where the Insurer is not the Holding Company and where the Holding Company of the Group is:

(a) another Insurer; or

(b) a Subsidiary of another Holding Company.

Guidance

1. The effect of Rule 2.2.4 is to avoid duplication arising from complex Group structures. If an Insurer is a member of a Group whose Holding Company is another Insurer, the first Insurer need not apply Rule 2.2.3 in respect of that Group, because the Insurer that is the Holding Company is already required to apply that Rule. Where an Insurer is a member of two or more Groups that are also sub-groups of a single Group, the Insurer may consider that single group as a whole for the purposes of this section. An Insurer that is a Holding Company is however still required to apply Rule 2.2.3 in respect of any Group of which the Insurer is the Holding Company.

2. An Insurer should describe how its risk tolerance limits described in Rule 2.2.1(c) link with its corporate objectives, business strategy and current circumstances. An Insurer is expected to embed its risk tolerance limits into its day-to-day operations and its risk management policies and procedures.

2.3 Management of particular risks

2.3.1 An Insurer must develop, implement and maintain a risk management system to identify and address balance sheet and market risk, including but not limited to:

(a) reserving risk;

(b) investment risk (including risks associated with the use of derivatives);

(c) underwriting risk;

(d) claims management risk;

(e) product design and pricing risk; and

(f) liquidity management risk.

2.3.2 An Insurer must develop, implement and maintain a risk management system to identify and address credit quality risk.

2.3.3 An Insurer must develop, implement and maintain a risk management system to identify and address the non-financial or operational risk of that Insurer, including but not limited to:

(a) technology risk (including processing risks);

(b) reputational risk;

(c) fraud and other fiduciary risks;

(d) compliance risk;

(e) outsourcing risk;

(f) business continuity planning risk;

(g) legal risk; and

(h) key person risk.

2.3.4 An Insurer must develop, implement and maintain a risk management system to identify and address reinsurance risk. Reinsurance risk refers to risks associated with the Insurer's use of reinsurance arrangements as cedant.

2.3.5 Without limiting the generality of Rule 2.3.4, an Insurer's risk management system in respect of its use of reinsurance arrangements must include the development, implementation and maintenance of a written reinsurance management strategy, appropriate to the size and complexity of the operations of the Insurer, defining and documenting the Insurer's objectives and strategy in respect of reinsurance arrangements.

2.3.6 ~~[Deleted] [VER6/07-07] [RM46/07]~~ An Insurer must develop, implement and maintain a risk management system which includes an explicit asset-liability management (ALM) policy, which must clearly specify the nature, role and extent of ALM activities and their relationship with product development, pricing functions and investment management.

Guidance

1. An Insurer's ALM policy should be appropriate taking into account the nature, scale and complexity of its ALM risks.

2. The ALM policy should include details as to how:

   (a) the investment and liability strategies adopted by the Insurer allow for the interaction between assets and liabilities;

   (b) the correlations are taken into account;

(c) the liability cash flows will be met by cash inflows; and

(d) the valuations of assets and liabilities will change under an appropriate range of different scenarios.

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7 ACTUARIES

7.1 Introduction

Guidance

This chapter requires an Insurer to provide the DFSA with a report by an Actuary in respect of its Insurance Liabilities and assets arising in respect of those liabilities (that is, assets which are contingent on the existence and amount of the liabilities, such as reinsurance, salvage and subrogation recoveries). Separate provisions apply in respect of reports on General Insurance Business and Long-Term Insurance Business.

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7.5 Qualifications of the actuary

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7.5.4 An Insurer must notify the DFSA immediately on the termination or resignation of its Actuary, giving the reasons for such termination or resignation.

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App2 MANAGEMENT AND CONTROL OF RISK

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A2.6 Investment risk

Guidance

1. Investment risk refers to the possibility of an adverse movement in the value of an Insurer's on-balance sheet assets or certain off-balance sheet obligations. Investment risk derives from a number of sources including market risk (e.g. equity, interest rate and foreign exchange risk), credit quality risk (dealt with separately in this appendix), investment concentration risk and asset and liability mismatch risk (e.g. in terms of currency, maturity, and location). Associated risks include political risk, e.g. the risk of inability to realise assets in a particular location, and the risk of correlation such that a single event has adverse impacts on both assets and liabilities. Investment risk includes risk associated with the use of derivatives and other complex investment instruments, including asset backed securities, credit linked notes and insurance linked notes.

2. Suitable controls and management information systems should be in place to enable an Insurer to implement an appropriate investment strategy.

3. Appropriate procedures should be in place to enable an Insurer to monitor the interaction of its assets and liabilities so as to ensure that exposure to equity, interest rate and foreign exchange risk is contained within limits approved by the Insurer. Procedures should include testing of sensitivity to realistic scenarios that are relevant to the circumstances of the Insurer.

4. Appropriate procedures should be in place to enable an Insurer to monitor the location of its assets and liabilities, so as to ensure that risk of localisation mismatch is contained within limits approved by the Insurer. Procedures should include testing of sensitivity to realistic scenarios, including political risk scenarios that are relevant to the circumstances of the Insurer.

5. Insurers should remain alert to the need to consider asset and liability risks on an integrated basis. Systems should not consider only risks taken in isolation, but should consider how even when individual risks are addressed, combinations of circumstances may still expose an Insurer to loss. This is of particular relevance where a single outcome is exposed to more than one risk, for example where assets need to be available not only in a particular location but also in a specific currency.

6. Appropriate procedures should be in place for assessing the credit-worthiness of counterparties to whom the Insurer is significantly exposed. Further guidance in this area is provided in A2.11.

7. Appropriate procedures should be in place for setting prudent limits for the Insurer's aggregate exposure to certain categories of asset. Such limits should take account of the suitability of assets covering Insurance Liabilities. They may take account of the Insurer's other assets bearing in mind the possibility that such assets might in future be needed to meet Insurance Liabilities.

8. The investment strategy should be reflected in clear terms of reference from the Insurer to its investment managers, who should be qualified and competent to carry out their assigned task. The work of the investment managers should be monitored sufficiently closely by management to ensure that the Insurer's strategy is being followed and that the systems are effective.

9. Insurers should ensure that controls over derivatives and other complex investment instruments have been implemented and are adequate to ensure that risks are properly assessed, regularly reviewed in the light of changing market conditions and experience, and consistent with the overall investment strategy decided upon and approved by the Insurer. In particular senior management and directors of Insurers should:

   a. fully understand the nature of derivatives trading <u>and trading in any other complex investment instruments</u> being undertaken by the organisation and the related risks, and where relevant, are suitably qualified and competent to transact the range and type of transactions being undertaken and understand the nature of the exposures (including both counterparty and market risk) which their use will create;

   b. have documented clearly the objectives and policies for the use of derivatives contracts <u>and other complex investment instruments</u>, and monitor their use (including by way of compliance audits of investment managers) to ensure their use is in line with those objectives and policies. Insurers should ensure that policies are sufficiently clear and precise to ensure that new types of instrument are not dealt in without due prior consideration. They should also define any associated limits on exposures or volumes that are considered appropriate;

   c. have due regard to uncovered transactions in the context of the above controls so that in no circumstances is the Insurer's capital adequacy endangered. Systems should be adequate to prevent exposure to unacceptable, exceptionally volatile risks and to monitor transactions with a frequency commensurate with volatility and risk. The systems should trigger a hedge or close out a transaction whenever adverse movements or events threaten a significant worsening of the Insurer's capital adequacy position;

   d. have ensured that those who have responsibility for the control of <u>investments in</u> derivatives <u>and other complex instruments</u> , are sufficiently independent of the day-to-day operators to ensure effective control;

   e. be capable of analysing and monitoring the risk of all transactions undertaken by the Insurer individually and in aggregate (including interest rate risk, foreign exchange risk, fraud, error, unauthorised access to information and other operational risks);

   f. be provided regularly with appropriate statistics and information on the trading volumes of derivatives contracts by type of product including regular reports of all off-balance sheet transactions, contingencies and commitments;

   g. be satisfied that sufficient systems and controls relevant to derivative products <u>and other complex investment instruments</u> have been put in place, including independent agreement and reconciliation of positions, independent checking of prices, appropriate authorisation where dealing limits have been exceeded, etc; and

h. have tested adequately and approved valuation models which are used to value open positions and derivative contracts <u>and other complex investment instruments</u>, including controls preventing unauthorised programme amendments. Such models should include appropriate testing of the robustness of the portfolio in changing investment conditions, using realistic scenarios relevant to the circumstances of the Insurer.

10. Stress and scenario testing should consider the impact of possible deteriorations in investment conditions, including where relevant the impact of simultaneous deteriorations in more than one market. It should also consider effects on liquidity, including where relevant those from an inability to repatriate assets from elsewhere. Where the insurance industry's holdings are large in relation to the turnover of the domestic market, scenario modelling should take account of the possible effect on the market of simultaneous liquidation of assets. [Added][VER5/06/07] [RM43/07]

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