

Circular No. ID 02/06

5 January 2006

To Principal Officers of All Insurers

Dear Sir/Madam

**MAS NOTICE 104 - USE OF DERIVATIVES FOR INVESTMENT OF INSURANCE
FUND ASSETS**

In exercise of the powers conferred by section 64(2) of the Insurance Act, the Monetary Authority of Singapore is revising the above-captioned Notice in order to refine certain provisions.

2 The revised Notice 104 takes effect on 6 January 2006.

3 MAS Notice 104 sets out the requirements on use of derivatives for investment of insurance fund assets. This Notice has been amended by removing the minimum credit rating requirements for counterparties to derivative contracts and financial instruments stapled with credit derivative contracts. The risk for such investments is addressed under the RBC framework through applying the appropriate risk charges or deductions from capital.

4 A copy of the revised Notice 104 is enclosed.

5 Please contact your company's liaison officer in MAS should you require further clarification.

Yours faithfully

[Sent thru MASNET]

LOW KWOK MUN
EXECUTIVE DIRECTOR
INSURANCE SUPERVISION DEPARTMENT
PRUDENTIAL SUPERVISION GROUP

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Notice No: MAS 104
Issue Date: 6 January 2006

This Notice replaces MAS 104 dated 28 August 2004.

NOTICE ON USE OF DERIVATIVES FOR INVESTMENT OF INSURANCE FUND ASSETS

Introduction

1. This Notice is issued pursuant to section 64(2) of the Insurance Act (Cap. 142) (“the Act”).
2. This Notice shall be read in conjunction with the provisions of the Act and the Insurance (Valuation and Capital) Regulations 2004 (G.N. No. S 498/2004) (“the Regulations”).
3. This Notice applies to any insurer registered to carry on insurance business.
4. This Notice shall not apply to the part of any investment-linked fund relating to the unit reserves of the policies of the fund.
5. With effect from 6 January 2006, MAS Notice 104 on “Use of Derivatives for Investment of Insurance Fund Assets” dated 28 August 2004 shall be cancelled and this Notice shall come into force.

Interpretation

6. For the purpose of this Notice:
 - (a) “Credit derivative contract” means any financial contract designed to transfer credit risk on loans or other assets between two parties. Participants may enter into credit derivative contract either as end-users purchasing credit protection or acquiring credit exposure from third parties, or as intermediaries for these activities;
 - (b) “Protection seller” means the party who contracts to receive premiums or interest-related payments in return for assuming the credit risk on an asset or group of assets from the protection buyer. The protection seller is also known in the market as the credit risk buyer or guarantor;
 - (c) “Protection buyer” means the party who contracts to transfer the credit risk on an asset or group of assets to the protection seller. The protection buyer is also known in the market as the credit risk seller or the beneficiary;
 - (d) “Hedging” means the reduction of investment risk through engaging in a transaction for a derivative on an investment where there is a high degree of negative correlation between the changes in value of the derivative and changes in value of the hedged investment; and

- (e) “Efficient portfolio management”, in relation to a derivative transaction, has the meaning ascribed in paragraph 13 below.

Prudent Management Oversight

- 7. An insurer shall exercise prudent management oversight and shall implement adequate controls in respect of derivative transactions, including but not limited to establishing clearly written policies and procedures on derivative transactions and laying down appropriate risk limits, which policies, procedures and risk limits have been approved by the Board of Directors. Where external asset managers are used, an insurer shall ensure that its senior management is in a position to monitor the performance of those managers against its approved policies and procedures.
- 8. An insurer shall implement and maintain adequate risk management systems and controls in respect of derivative transactions. These shall include, but not be limited to, ensuring that:
 - (a) there is proper segregation of execution and monitoring/performance measurement functions;
 - (b) the authority of persons entering into, performing or otherwise dealing in derivative transactions for and on behalf of the insurer, and limits of such authority, are clearly delineated;
 - (c) there are proper performance monitoring procedures;
 - (d) there are continuous risk monitoring procedures;
 - (e) there is timely management reporting;
 - (f) dealings in derivatives are handled by qualified and properly trained persons; and
 - (g) there are sound audit procedures to ensure compliance with the insurer's policies and procedures and statutory requirements.

Permitted Derivatives Activities

- 9. In view of the potential significant financial losses that could arise from speculative trades, an insurer shall, subject to paragraph 14, only be permitted to enter into or effect derivative transactions for the purposes of hedging and efficient portfolio management.

Hedging

- 10. An insurer shall clearly identify any derivative transaction entered into for hedging purposes as a hedge. The insurer shall promptly unwind the transaction if the transaction does not have the effect of hedging at any stage during the period of the derivative contract.

11. An insurer shall exercise extra caution whilst hedging foreign currency risk where the underlying investment does not have a fixed payment schedule (e.g. equities).
12. An insurer shall disclose in its annual statutory returns its accounting policies as well as exposure to derivatives (including the amount and percentage of derivatives investment of total insurance fund assets, for each insurance fund separately).

Efficient Portfolio Management

13. A derivative transaction shall be deemed to have been effected for the purpose of efficient portfolio management if:
 - (a) it is economically appropriate;
 - (b) the exposure is fully covered (to meet any obligation to pay or deliver); and
 - (c) it has at least one of the following aims:
 - * reduction of risk;
 - * reduction of cost with no increase in risk or a minimal increase in risk; or
 - * generation of additional capital or income for the scheme with no increase or a minimal increase in risk.

Prohibitions

14. An insurer shall not take uncovered positions in derivatives. For currency, stock index, and interest rate forward and futures contracts, cash or near cash assets (amounts deposited with or loaned to financial institutions to be redeemed before delivery date) shall be provided for in the insurance fund to back the full value of the contracts. This requirement shall extend to the value of interest rate swaps and the notional amount of underlying assets for unfunded credit derivative contracts and short options positions.

Contravention of requirements imposed

15. Contravention of any requirement imposed under this Notice shall be an offence and shall attract the penalty specified in section 55(2) of the Act.