<u>**GL13**</u>

GUIDELINE
ON
ASSET MANAGEMENT
BY AUTHORIZED INSURERS

Insurance Authority

Contents **Page**

1. Preamble

1.1. The nature of the insurance business implies the formation of technical provisions, and investment in and the holding of assets to cover these technical provisions and a solvency margin. In order to ensure that an authorized insurer can meet its contractual liabilities to policyholders, such assets must be managed in a sound and prudent manner taking account of the profile of the liabilities held by the insurer and, indeed, the complete risk-return profile. The complete risk-return profile should result from an integrated view on product and underwriting policy, reinsurance policy, investment policy and solvency level policy. The liabilities profile of an authorized insurer 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 thus follows that the need, for example, to maintain a high degree of liquidity within the asset portfolio will similarly differ between authorized insurers. Differences in the accounting and taxation treatment of the various types of insurance business may also influence investment decisions.

1.2. This Guideline is issued pursuant to section 133 of the Insurance Ordinance (Cap. 41). Its objective is to describe the essential elements of a sound asset management system and reporting framework across the full range of investment activities. The Guideline thus provides a good checklist in assessing how authorized insurers should control the risks associated with their investment activities. Given the wide variation in the nature of insurers, it is acknowledged that the extent of the application of the practices described in the Guideline by any given authorized insurer may differ according to the size and structure of the insurer and the type of business it conducts. However, the basic principles of the Board of Directors ("Board")' responsibility, the need for an investment policy, segregation of duties and control will be applicable to all authorized insurers.

1.3. The Guideline shall apply to an authorized insurer incorporated in Hong Kong and the Hong Kong branch of an authorized insurer incorporated outside Hong Kong whose investment in financial assets (see paragraph 2.2 below) exceeds HK$100 million. An authorized insurer which has ceased insurance underwriting in Hong Kong and is running off its Hong Kong insurance business is exempted.

2. Introduction

Asset Liability Management

2.1. A key driver of the asset strategy adopted by an authorized 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 those 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. The analysis will involve, *inter alia,* the testing of the resilience of the asset portfolio to a range of market scenarios and investment conditions, and the impact on the insurer's solvency position. An authorized long term business insurer will inevitably also take into account the relevant input from its appointed actuary.

The Investment Process

2.2. Depending upon the nature of their liabilities authorized insurers will typically hold, in varying proportions, four main types of financial assets either directly, via other investment vehicles (such as 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.

2.3. The holding of a given asset portfolio carries a range of investment-related risks to technical provisions and solvency which authorized 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.

2.4. 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 Guideline is regarded as a circular movement characterised 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 which have been achieved and the risks taken;

(d) Feedback to the appropriate level of authority on points (a), (b) and

2.5. Authorized 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, based on an assessment of the risks incurred by the insurer 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 insurer and, as appropriate, at group level, at any given time. Such systems will vary from insurer to insurer, but should be:

    (i) sufficiently robust to reflect the scale of the risks and the investment activity undertaken;

    (ii) capable of accurately capturing and measuring all significant risks in a timely manner;

    (iii) understood by all relevant personnel at all levels of the insurer;

(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 insurer;

(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.

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

3. Definition of the Investment Policy and Procedures

Board of Directors

3.1. The Board should be responsible for the formulation and approval of the strategic investment policy, taking account of the analysis of the asset/liability relationship, the authorized insurer's overall risk tolerance, its long-term risk-return requirements, its liquidity requirements and its solvency position. For a long term business insurer, the Board should also consider the relevant input of its appointed actuary. Alternatively, the Board can delegate formulation of the strategic investment policy, including consideration of the factors listed, to an appropriately constituted committee such as the Investment Committee as mentioned in the Guideline on the Corporate Governance of Authorized Insurers (GL10) issued by the Insurance Authority ("IA"), whilst retaining the power of ratification.

3.2. 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[1] 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.

3.3. The Board 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 vehicles;

---

[1] Passive management refers to the situation where investment transactions are undertaken in order to maintain a predefined strategic mix between asset categories, or within an asset category, possibly in accordance with market indices. Active management on the other hand refers to the situation where transactions are undertaken in order to deliberately deviate from the predefined strategic mix to achieve a risk-return profile different from that implied by the strategic portfolio composition. This may take place at various levels, e.g. by changing the portfolio mix between equities and fixed income investment, altering the geographical allocation, or, in an equity portfolio, over- and underweighting of shares against an index, and, in a fixed income portfolio, increasing or decreasing the duration of the portfolio.

(b) The selection and use of brokers;

(c) The nature of custodial arrangements;

(d) The methodology and frequency of the performance measurement and analysis.

3.4. The Board should authorize senior management to implement the overall investment policy. The Board must, however, always retain ultimate responsibility for the authorized insurer's investment policy and procedures, regardless of the extent to which associated activities and functions are delegated or, indeed, outsourced.

3.5. As part of the development of the asset management strategy the Board must also ensure that adequate reporting and internal control systems of the authorized 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 regulatory requirements. The Board must ensure that:

(a) They receive regular information, including feedback from the insurer'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 unauthorized risk taking.

3.6. 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 authorized 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.

3.7. 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.

3.8. At least annually, the Board should review the adequacy of its overall investment policy in the light of the authorized insurer's activities, and its overall risk tolerance, long-term risk-return requirements and solvency position and the local asset requirement for a general business insurer.

Senior Management

3.9. 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 will frequently be delegated to senior management. The precise content of the mandate will be different for each authorized insurer 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 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 authorized 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), authorized counterparties;

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

3.10. 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 (with the methods of accounting concerned being subject to generally accepted accounting practice and accepted by the auditor) 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 non-compliance;

(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.

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

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

4. Monitoring and Control

Risk Management Function

4.1. Authorized 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.

4.2. The risk management function should also assess the appropriateness of the asset allocation limits. To do this, regular resilience testing should be undertaken for a wide range of market scenarios and changing investment and operating conditions. Once an authorized insurer 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.

4.3. The risk management function should 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 authorized insurer 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 insurer’s solvency.

Internal Controls

4.4. 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 authorized insurer’s approved policies and procedures. Internal control procedures should be documented. The extent and nature of internal controls adopted by each authorized 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 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.

4.5. 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.

4.6. Regular and timely reports of investment activity should be produced which describe the authorized insurer’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.

Audit

4.7. Authorized insurers should have an audit that includes full coverage of their investment activities and ensures timely identification of internal control weaknesses and operating system deficiencies. If the audit is performed internally it must be independent. Concerns with regards to investment activity must be reported to senior management and the Board.

4.8. Audit coverage should be provided by competent professionals who are knowledgeable of the risks inherent in all assets held.

4.9. Auditors should be expected to evaluate the independence and overall effectiveness of the authorized insurer'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.

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

5. Supervision

5.1. In monitoring the asset management of authorized insurers, IA will seek to ensure that the insurers have the ability to identify, monitor, measure, report and control the associated risks. In order to achieve this objective, the insurers should have in place an overall investment policy and procedures approved by the Board, including procedures that ascertain that the Board receives appropriate quantitative and qualitative information on the investment activities and asset positions. IA may also wish to satisfy itself that the insurers 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 their liabilities profiles.

5.2. In order to assess how authorized insurers control the risks associated with their investment activities, IA may periodically request the following information:

(a) A description of the Board's overall approach and policy on products and underwriting, reinsurance, investment and solvency;

(b) Asset/liability management procedures;

(c) Specific details of the investment policy, and monitoring and control procedures including:

(i) the asset classes approved by the Board for use by the insurer and details of portfolio composition;

(ii) procedures for the approval of counterparties;

(iii) procedures for seeking approval to use new investment instruments and for ensuring that asset risk controls, once established, keep pace with the emergence of new investment instruments;

(iv) procedures covering front and back office functions, measurement of compliance with any limits, oversight, control and reporting;

(v) the limits to credit, market, and other risks;

(vi) procedures for monitoring liquidity risk;

(vii) the professional qualifications of those entrusted with investment activities;

(viii) the valuation methodologies;

(ix) compliance reports;

(x) the procedures for selecting and monitoring any external asset managers used;

(xi) the risk position of the asset portfolio, using, for example, value at risk calculations or other methodologies.

5.3. This information should be accessible to IA through on-site inspections and discussions with authorized insurers. It may make use of internal management information on asset portfolios. Information should be timely and comprehensive (i.e. it should include all assets held and cover the entire reporting entity). In cases where the insurers outsource all or part of their asset management, they should still be responsible for ensuring the availability of information for supervisory purposes.

6. Commencement

6.1. This Guideline shall take effect from 26 June 2017.

June 2017