BANK OF PAPUA NEW GUINEA

LIFE INSURANCE PRUDENTIAL STANDARD

7/2008

LIFE INSURANCE COMPANIES INVESTMENTS

ARRANGEMENT OF SECTIONS

PART 1—PRELIMINARY

1) ***Title:*** This Standard may be cited as ***Life Insurance Prudential Standard No. 7/2008 Life Insurance Companies Investments***.
2) ***Authorization:*** The Bank of Papua New Guinea, acting under Section 48 of the ***Life Insurance Act 2000*** and all other powers enabling it, determines this Standard.
3) ***Application***: This Standard prescribes requirements about life insurance company investments and related matters. Life insurance companies must comply with it.
4) ***Interpretation***: In this Standard, unless the contrary intention appears—
   a) "Act" means the ***Life Insurance Act 2000***, and regulations, other prudential standards, licences, authorities and other instruments made under or for the purposes of that Act.
   b) "associate", in relation to a person, means any of the following—
      i) a relative of the person;
      ii) a body corporate of which the person is a director;
      iii) an employee or partner of the person;
      iv) if the person is a company—
         (1) a director or employee of the company; or
         (2) a subsidiary of the company; or
         (3) a director or employee of a subsidiary of the company;
      v) in relation to a body corporate—if the person has an agreement or arrangement with another person with respect to the acquisition, holding or disposal of shares or other interests in the body corporate, or under which they undertake to act together in exercising their voting power in relation to the body corporate—the other person.
   c) "custodian" means a person that provides services generally called custody services.

Commentary

1. Custody services include services such as clearing, settlements, safekeeping of assets, investment administration and reporting to the trustees or investment managers. They do not include investment management services.

d) "derivative" means a financial asset or liability the value of which depends on or is derived from other assets, liabilities or indexes.

e) "investment management agreement" means an agreement between the life insurance company and an investment manager for the provision of investment management services for the life insurance company.

f) "investment manager" means an entity or person providing or purporting to provide investment management services.

g) "life insurance company" means a life insurance companies licensed under the Act to carry on life insurance business in PNG.

h) "market value" of an asset means the amount that it would be reasonable to expect a buyer to pay for the asset if the parties to the transaction were dealing with each other at arm's length.

Commentary

1. Assets acquired for no consideration, for less than market value or for more than market value are all valued at market value. In particular, the life insurance company's interest in leased property (either as lessor or lessee) is valued at the market value of its interest in the property.

Commentary on definitions

1. The following are defined in section 3 of the Act:
   - "group"
   - "property"
   - "relative"

5) ***Commentary***: Commentary in this Standard is included for guidance.

PART II—STATEMENT OF POLICY

6) ***Purpose***: This Standard prescribes requirements about investments of a life insurance company and related matters. Certain aspects are applicable to the company as a whole while some are related to the investments of the statutory fund only.

7) ***Scope***: All life insurance companies must comply with this Standard.

8) ***Responsibility***: It is the responsibility of the board of directors of the life insurance company to comply with this standard.

PART III—INVESTMENT MANAGERS AND CUSTODIANS

9) Appointing Investment Managers

a) A life insurance company may appoint one or more external investment managers.

b) In selecting an investment manager, the life insurance company must—

   i) use proper tendering and selection processes; and

   ii) conduct all necessary and appropriate "due diligence" inquiries into proposed investment managers.

c) An appointment of an investment manager for a life insurance company must be in writing.

d) This standard does not preclude a life insurance company from appointing a suitably qualified individual as its investment manager, nor does it preclude an associated company being appointed as investment manager.

e) The life insurance company may only appoint another entity as investment manager that:

   i. at the time of appointment; and

   ii. at all times that the investment management agreement remains in force;

   employs only persons who would satisfy the requirements of the Act as though those persons were employed directly by the life insurance company.

f) When an investment manager is appointed, the life insurance company shall advise the Central Bank in writing within 10 working days.

Commentary

1. A life insurance company may undertake its own investment activity or appoint external managers to act on its behalf.
2. This prudential standard outlines the expectations of the Central Bank regarding the appointment and management of such appointments.
3. A life insurance company may wish to appoint different managers for different investment sectors.
4. The Fit & Proper requirements applicable to a life insurance company will be applied to an entity acting as an investment manager on a look through basis.

10) Investment Management Agreements

a) The life insurance company must ensure that, so long as the appointment of an investment manager lasts, there is in force at all times a written investment management agreement between the investment manager and the life insurance company that complies with this Standard.

b) An investment management agreement must—

   i) clearly set out the terms on which the investment manager is engaged, including the fees payable to the investment manager and how the costs and expenses incurred by the investment manager are to be borne; and

   ii) clearly set out the functions and duties that each party is to perform; and

   iii) require the investment manager to comply at all times with this standard; and

   iv) clearly specify each of the following—

      (1) the parameters, constraints, performance standards and benchmarks for investments and investment decisions;

      (2) performance indicators for the investment manager;

      (3) the ownership of and rights of access to books and records relevant to the investment management agreement;

      (4) the processes for resolving disputes between the parties;

      (5) the rights of each party to indemnity from the other;

      (6) the terms of the agreement;

      (7) the rights of each party to terminate the agreement;

      (8) the obligations of each party on termination of the agreement; and

   v) require the investment manager to report regularly, at least monthly to the life insurance company , and specify the contents of reports; and

   vi) require the investment manager to comply with any request for information relevant to the assets of the life insurance company, the investment management agreement or the ability of the investment manager to perform its obligations under the investment management agreement.

Commentary

1. For subparagraph b) it should be noted that the Act requires officers (defined as including all staff) of a life insurance company to be fit and proper; see section 20.
2. For subparagraph c) (iv) (1)—the "parameters, constraints, performance standards and benchmarks for investments and investment decisions" include the investment objectives and investment strategy for the life insurance company, and provide for what happens when the life insurance company varies them.
3. For subparagraph c) (iv) (5)—subsection 53 (2) of the Act says that a service contract cannot derogate or diminish the responsibilities of the licence holder under the Act.

11) Custodian

a) The life insurance company, in consultation with any investment manager, will ensure that custodial arrangements for all its investments are satisfactory to the Central Bank.

Commentary

1. It is not necessary to appoint an external custodian unless the nature of the investments warrants such an appointment.

PART IV—INVESTMENT OBJECTIVES AND INVESTMENT STRATEGIES

12) Investment Objectives

a) The directors of a life insurance company must formulate an investment objective for the statutory fund of the life insurance company.

b) The investment objective must be recorded in writing.

c) An investment objective for the statutory fund of a life insurance company must—

   i) specify the desired investment outcome for the life insurance company; and

   ii) be capable of being clearly communicated so that policyholders can understand the investment approach of the life insurance company; and

   iii) be such that the extent to which the investment objective has been met can be easily determined.

Commentary

1. Investment objectives must be measurable. A suitable investment objective would state a performance benchmark or a desired level of return, for example, “The company’s investment objective is to earn, on average over a 5 year period, at least 2% above CPI”. Actual results can then be readily measured against the investment objective and reported to policy owners, if appropriate.
2. While the standard addresses the investment strategy for the statutory fund, life insurance companies must hold appropriate assets in the shareholder fund to meet the requirements of *Prudential Standard 1/2002 Financial Requirement For Life Insurance Companies*.

13) Determinations related to Investment Strategies

a) For the purpose of formulating an investment strategy, the directors of a life insurance company must determine—
   i) the level of risk, the level of volatility of returns, and the diversification of assets, that it considers acceptable in connection with investments of the Statutory Fund of the life insurance company; and
   ii) the desired level of liquidity for the Statutory Fund.

b) A determination under this section must be in writing.

c) In making a determination under subsection (a), the directors must—
   i) have regard to all the circumstances of the life insurance company; and
   ii) seek and take into account advice from the appointed actuary.

d) In making a determination under paragraph (a) (ii), the directors must also take into account—
   i) the amount it considers should be invested in cash or in assets readily convertible to cash; and
   ii) the expected timing of investment income and premiums; and
   iii) actual or contingent expenditure requirements, for example, taxation or payment of policy benefits.

14) Investment Strategies

Commentary

1. Section 85 (1) of the Act provides, that as a general rule, the life insurance company may invest in any way that is likely to further the business of a statutory fund. Subsection (2) gives the following qualifications-
   - all investments of statutory funds shall be conducted at arm's length;
   - all property of the licence holder shall remain unencumbered; and
   - prudential standards may prescribe restrictions on investments.

   The Central Bank takes these provisions to mean that life insurance companies should utilise a diversified investment approach for statutory funds.
2. The Central Bank requires the directors to formulate and give effect to an investment strategy that has regard to the whole of the circumstances of the life insurance company including, but not limited to, the following—
   a. the risk involved in making, holding and realising, and the likely return from, the Statutory Fund's investments having regard to its objectives and its expected cash flow requirements; and
   b. composition of the Statutory Fund's investments as a whole including the extent to which the investments are diverse or involve the entity being exposed to risks from inadequate diversification; and
   c. the liquidity of the Statutory Fund's investments having regard to its expected cash flow requirements; and
   d. whether or not there are participating contracts; and
   e. whether or not there are contracts that provide an investment return to policyholders; and
   f. the ability of the entity to discharge its existing and prospective liabilities

a) An investment strategy for a life insurance company must be in writing.

b) An investment strategy for a statutory fund must specify each of the following—
   i) performance benchmarks for the returns the life insurance company is seeking to achieve;
   ii) determinations under paragraph 14;
   iii) the diversification to be maintained within asset classes and between asset classes;

iv) if there are to be restrictions or prohibitions on investing in assets of a particular category—what those restrictions and prohibitions are;

v) any restrictions on the life insurance company's holding investments in a single entity or group;

vi) any minimum liquidity standards for particular categories of investments;

vii) factors that are peculiar to the life insurance company and the Statutory Fund.

Commentary

1. For paragraph (b) (iii). The Central Bank notes that diversification is generally expected to result in a lower overall level of risk to achieve a specified return. Diversification may involve spreading investments—
   - over a number of individual assets, asset classes (domestic equities, property, fixed interest, cash, international equities); and
   - within each asset class, such as investing in commercial and residential property, and in long and short term fixed interest investments.
2. The desirable level of diversification and how it is achieved will depend on the size and circumstances of the life insurance company.

c) In formulating and reviewing an investment strategy for the statutory fund, the life insurance company must —

i) seek and take into account advice from the life insurance company's appointed actuary; and

ii) take into account the following (in addition to the matters that it must take into account under Section 85 of the Act)—

(1) the business profile of the Statutory Fund;

(2) the reasonable expectations of policyholders;

(3) the nature and expected timing of policyholder benefits;

(4) the size of the Statutory Fund;

(5) taxation considerations relevant to the life insurance company and to policyholders;

(6) limitations and constraints on investments imposed by law or by some other instrument, including the life insurance company's governing rules;

(7) any reports from experts or other qualified professionals;

(8) any actual or potential conflicts of interest involving the life insurance company, the investment manager or an associate of the life insurance company or the investment manager.

Commentary

1. In supervising life insurance companies, the Central Bank will look for evidence that the specific matters under this section, have been taken into account when formulating the investment strategy. This may be demonstrated through Board minutes and by other documentation (say, reports from investment advisers) and by the actual wording of the investment strategy.
2. For subparagraph (c) (ii) (6)—"ethical" or environment-friendly investment rules may be examples of these limitations.

d) An investment strategy for a life insurance company must be clearly expressed, so that policyholders and prospective policyholders can easily understand it, and can assess the investment performance and management of the life insurance company.

Commentary

1. A widely used method is to set formal asset allocation ranges of minimum and maximum exposure permitted for each asset class with a benchmark for each asset class.

PART V—MAKING INVESTMENTS

Commentary

1. Giving effect to (or implementing) the strategy is a separate process from formulating it. Implementing a strategy involves considerations such as the value of life insurance company's assets, the expertise of the life insurance company, the availability of appropriate advice, administrative capacity and the costs of managing investments. It may involve direct investment, indirect investment (say, through collective investments), using investment vehicles or managers or a combination of these approaches.
2. It is recognised that life insurance companies will invest in a range of assets including some that may be regarded as not readily marketable such as property.

Division 1—General Rules

15) Investments to be consistent with investment strategy

a) The life insurance company and any investment manager of a life insurance company must not make an investment for the statutory fund unless the investment is consistent with the investment strategy of the statutory fund.

b) If investments of a statutory fund cease to be consistent with the investment strategy of the statutory fund:

   i) the investment manager of the life insurance company must notify the life insurance company as soon as practicable; and

   ii) the life insurance company and the investment manager, where appointed, of the life insurance company must take appropriate steps to ensure that the statutory fund's investments are consistent with the investment strategy of the statutory fund.

16) Offshore Investments

a) A life insurance company may, if the investment strategy of the statutory fund permits, invest money offshore by way of —

   i) deposits with financial institutions subject to equivalent prudential supervision to that in force in PNG;

   ii) securities listed on a recognised stock exchange that is a member of the World Federation of Exchanges;

   iii) securities issued by foreign governments where the security is classed as investment grade by an international rating agency; and

   iv) collective investments such as unit trusts and property trusts.

17) Requirement to Report Large Exposures

a) The life insurance company must report to the Central Bank if 5% or more of the value of the life insurance company's assets consist of investments in a single entity or a single group. The report must be made as soon as practicable after the life insurance company becomes aware of the matter, and updated as required by the Central Bank.

Commentary

1. Large exposures may arise from acquisition, through market movements in valuation, or through asset valuation.
2. If market movements in valuation or asset revaluation cause the percentage holding to rise above the limits in 2. the Central Bank expects the directors to develop a diversification strategy satisfactory to the Central Bank to avoid the holding rising above another 5%. Should the holding rise above that level, the Central Bank will notify the life insurance company and the Investment Manager of the need for realistic divestment arrangements, reflecting the nature of the market situation, to be effected within a period stipulated by the Central Bank in order to reduce the beneficial holding .

Division 2—Financial Accommodation

18) Prohibition on Financial Accommodation

a) Except as permitted by the Act or regulation, a life insurance company, shall not mortgage or charge any of the property of a statutory fund to obtain financial accommodation; or for any other purpose.

Commentary

1. While Section 82 (3) prohibits charging of the statutory fund to obtain financial accommodation, Section 85 (2) of the Act requires that all life insurance company assets be unencumbered, and thus, not charged or used as security for financial or other obligations.

Division 3—Arm's length

19) Investments to be Arm's Length—Records

a) The directors or an investment manager of a life insurance company must not make an investment for the statutory fund of the life insurance company, unless it has recorded in writing the reasons why it considers that the investment will be conducted at arm's length.

General commentary on arm' length transactions

1. Section 85 (2) of the Act requires that all statutory fund investments be conducted at arm's length.
2. The "arm's length" requirement in section 85 (2) of the Act does not itself prevent investments in related parties of the life insurance company.
3. The Central Bank considers that a life insurance company conducts an investment at arm's length if a prudent person, acting with proper regard for

its own commercial and financial interests, would have done what the life insurance company did. The Central Bank considers that whether an investment complies with this rule must be determined in the light of all the circumstances of the investment, including—

- whether the asking price is fair, given the expected return on the asset, the risks to which the asset is exposed and its relative liquidity; and
- whether the projected returns of income and capital are in line with market expectations;
- whether the investment contract adequately protects the life insurance company and clearly identifies the parties' rights and obligations; and
- any valuations of the investment; and
- whether the asset is a depreciating asset.

4. The Central Bank expects that all life insurance company investments will be entered into and maintained on commercial terms, or on terms that are no more favourable to the other party than would reasonably be expected if the dealing were at arm's length in similar circumstances. For example, the purchase price of an investment should be at market value (or a value more favourable to the life insurance company than to the other party), and the agreed or expected return from the investment should be at not less than a true market rate.

20) Rights against Associates and Related Parties to be Enforced

a) Each of the directors and investment manager of a life insurance company must enforce its rights in respect of an investment of the life insurance company an entity that is:

   i) an associate of the directors of the life insurance company or investment manager; or

   ii) a related party of the life insurance company;

   in the same way, and to the same extent, as it would enforce similar rights in similar circumstances against a person that was not such an associate or related party.

Division 4—Derivatives

21) Derivatives

a) The directors and the investment manager, where appointed, of a life insurance company must ensure that the assets and liabilities of the statutory fund do not at any time include a derivative.

b) Subsection (a) does not prevent the assets and liabilities of the life insurance company including:

   i) derivatives consisting of forward purchases of currency; or

   ii) derivatives used as hedging instruments within a foreign collective investment if the derivatives are held as incidental to the life insurance company's interest in the foreign collective investment.

Commentary

1. Generally derivatives must not be used, whether to speculate or to minimise risk by protecting assets against changes in the market (hedging).

Division 5—Monitoring and Review

22) Regular Review of Investments

a) The directors and investment manager, where appointed, of a life insurance company must conduct regular reviews of the statutory fund's investments to ensure that they are consistent with the statutory fund's investment objectives and investment strategy.

b) The reviews must be carried out regularly, and as frequently as is appropriate having regard to the nature of the investments.

Commentary

1. The amount, complexity and type of investments will govern the frequency and style of monitoring. The Central Bank expects that such reviews will be undertaken at least every quarter.
2. If asset ranges are specified, investments must be regularly reviewed to ensure they are maintained within these ranges and that they are adjusted as necessary in the light of market movements.
3. The Central Bank expects that adequate and effective procedures will be in place to monitor direct investments in particular assets. This includes monitoring of performance to ensure that the investments remain relevant and appropriate, the receipt and recording of income and obtaining proper valuations.

4. Directors should also ensure that adequate and effective procedures are in place to monitor indirect investments. This includes monitoring of performance to ensure that the investments remain relevant and appropriate, and the receipt of regular and timely transaction reports.

23) Regular Review of Investment Strategies

a) The directors and the investment manager, where appointed, of a life insurance company must conduct reviews of the statutory fund's investment strategy to ensure that it remains appropriate to circumstances of the statutory fund.

b) The reviews must be carried out regularly, and as frequently as is appropriate having regard to the nature of the investments.

c) In conducting a review, the following must be taken into account:

   i) all the circumstances of the life insurance company, including the matters specified in Section 85 of the Act; and

   ii) any actual or proposed changes to the life insurance company or to external conditions; and

   iii) without limiting paragraphs (a) and (b)—

      (1) relevant amendments or proposed amendments to legislation; and

      (2) growth or decline in business; and

      (3) changes in business profile; and

      (4) changes in the general economic climate or specific markets (including financial markets); and

      (5) changes in service providers to the life insurance company.

PART VI—MISCELLANEOUS

24) Record Keeping

a) The directors of a life insurance company must keep complete and accurate records of—

   i) the steps it takes in selecting investment managers and custodians; and

   ii) the steps it takes to monitor and review the performance of investment managers and custodians, and actions taken as a result of those reviews.

b) The investment manager of a life insurance company must keep complete and accurate records of—

i) the steps it takes in selecting custodians; and

ii) the steps it takes to monitor and review the performance of custodians, and actions taken as a result of those reviews.

c) The directors and investment manager of a life insurance company must keep complete and accurate records of—

i) the procedures adopted to monitor and review life insurance company investments (direct and indirect) and actions taken as a result of those reviews;

ii) the procedures adopted to monitor and review the life insurance company's investment strategy, and actions taken as a result of those reviews.

PART VII—CORRECTIVE MEASURES

25) Remedial Measures and Sanctions

a) If a life insurance company fails to comply with this Standard, the Central Bank may impose or vary conditions on the licence to ensure compliance or, if necessary, suspend or revoke the license.

b) Any life insurance company which experiences difficulty in complying with the standard should advise the Central Bank forthwith.

PART VIII—EFFECTIVE DATE

26) ***Effective Date***: The effective date of this Prudential Standard shall be 1 December 2008.

27) ***Questions and enquiries*****:** Queries relating to this Prudential Standard should be addressed to**:**

The Manager,
The Financial Systems Supervision Department
Bank of Papua New Guinea
P.O Box 121
Port Moresby, N.C.D
Telephone: +675 322 7222, Fax: +675 321 4548