



बीमा विनियामक और विकास प्राधिकरण  
INSURANCE REGULATORY AND  
DEVELOPMENT AUTHORITY

CIRCULAR

REF: IRDA/F&I/INV/CIR/138/06/2014

11 June, 2014

The CEOs of all Insurers,

**SUB: Guidelines on Interest Rate Derivatives**

IRDA permitted Insurers to deal in Financial Derivatives only to the extent permitted and in accordance with the guidelines issued by the Authority vide Regulation 11 which got inserted in 2004 in the IRDA (Investment) Regulations, 2000. Accordingly, the Authority issued detailed Guidelines on Fixed Income Derivatives vide Circular no. INV/GLN/008/2004-05dt.24/08/2004. The said guidelines, inter-alia, permits the Insurers to enter Forward Rate Agreements (FRAs), Interest Rate Swaps (IRS), Exchange Traded Interest Rate Futures (IRF) with a maximum tenure of 1 year to hedge the Interest Rate risk on Investments and the forecasted transactions.

Need was felt by the Authority to review the above guidelines in view of the change in Investment environment, product structures, change in guidelines by RBI, SEBI, etc. The Authority also received representations from some of the Insurers to revisit the earlier guidelines and to permit the Insurers to hedge their Interest Rate risk with longer term Interest Rate Derivatives. Accordingly, "Draft guidelines on Fixed Income Derivatives" were issued on 18<sup>th</sup> June, 2013 and comments were sought from all the stakeholders.

After careful examinations of the comments received, the Authority now withdraws the earlier guidelines and issues fresh guidelines under Reg. 15 of IRDA (Investment) Regulations, 2000 as under:

**A) Insurers are allowed to deal as user with following types of Rupee Interest Rate Derivatives to the extent permitted, and in accordance with these guidelines.**

- i) Forward Rate Agreements (FRAs);
- ii) Interest Rate Swaps (IRS); and

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- iii) Exchange Traded Interest Rate Futures (IRF).

Participants can undertake different types of plain vanilla FRAs/IRS. IRS having explicit/implicit option features are prohibited. It is to be noted that FRAs and IRS are Over-the-counter (OTC) contracts.

**B) Permission to Insurers in the Rupee Interest Rate Derivatives are in general governed by the guidelines issued by the Reserve Bank of India (RBI) vide circular Nos:**

- i) IDMC:MSRD.4801/06.01.03/2002-03 dated June 3, 2003,
  - ii) DBOD No. BP. BC. 86/21.04.157/2006-07 (RBI/2006-2007/333) dated April 20, 2007
  - iii) DBOD.No.BP.BC. 27/21.04.157/2011-12 (RBI/2011-12/136) dated 2 August, 2011
  - iv) DBOD.No.BP.BC. 44 /21.04.157/2011-12 (RBI/2011-12/243) dated 02 November, 2011
- and as amended by RBI from time to time.

Also, compliance needs to be done of circulars issued by Securities and Exchange Board of India (SEBI) as applicable and amended from time to time.

**C) Permitted purpose of Dealing in Interest Rate Derivatives :**

**Hedging for forecasted transactions:**

- a. Reinvestment of maturity proceeds of existing fixed income investments;
- b. Investment of interest income receivable;
- c. Expected policy premium income receivable on the Insurance Contracts which are already underwritten in Life and Pension & Annuity business in case of Life Insurers and General Insurance business in case of General Insurers.

The overriding principle of any use of the above listed derivatives is that they must be used for hedging purposes only to reduce the interest rate risk in the company. The company must be able to demonstrate that this principle is adhered to.

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**D) Regulatory Exposure and Prudential Limits :**

- i) The counter parties necessarily have to be Commercial Banks and Primary Dealers (PDs) as permitted by RBI for FRAs and IRS.
- ii) Insurers dealing in FRAs and IRS have to arrive at the credit equivalent amount for the purposes of reckoning exposure to a counter-party.

For the purpose of exposure norms, Insurance companies shall compute their credit exposures, arising on account of Interest rate derivative transactions using the Current Exposure Method (CEM) as detailed below:

- The Credit Equivalent Amount of a market related off-balance sheet transaction calculated using the current exposure method is the sum of current credit exposure and potential future credit exposure of these contracts.
- Current credit exposure is defined as the sum of the gross positive mark-to-market value of these contracts. The Current Exposure Method requires periodical (at agreed periodicity) calculation of the current credit exposure by marking these contracts to market, thus capturing the current credit exposure.
- Potential future credit exposure is determined by multiplying the notional principal amount of each of these contracts irrespective of whether the contract has a zero, positive or negative mark-to-market value by the relevant add-on factor indicated below according to the nature and residual maturity of the instrument.

**Credit conversion factors:**

Notional principal amount of each FRA/IRS is to be multiplied by the conversion factor given below :

<b>Residual Maturity</b>	<b>Conversion Factor per year</b>
One year or less	0.5 per cent
Over One year to five year	1.0 per cent
Over five years	3.0 per cent

(Eg: If IRS of Rs. 10 crore maturity 4 years is entered into by the Insurance company with the counter party A, then the potential future credit exposure =  $10 \times 3.5\%$  = Rs. 0.35crore (i.e.  $3.5\% = 0.5\%$  for First year +  $1\%$  for next each year for 3 years as the duration is 4 years) )

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- iii) The Credit Equivalent Amount of the FRA/IRS shall be used for reckoning counter party credit exposure for the purposes of the Insurance Regulatory and Development Authority (Investment) Regulation, 2000.
- iv) For exchange traded IRFs, the industry exposure limit is calculated against the Central Counter Party i.e. Clearing Corporation on the basis of above Credit Equivalent Amount in D(ii).
- v) Exposure limits pertaining to single Issuer, Group and Industry will be applicable for the exposure through FRA and IRS contracts. No contracts shall be entered with promoter group entities either directly or indirectly. Counter party rating shall be considered for calculating the pattern of investments. The limits shall be reported in the remarks column of the respective quarterly returns.
- vi) A Participant's dealing in Interest Rate derivatives under these guidelines shall in aggregate not exceed an outstanding notional principal amount equivalent to 100% of the book value of the fixed income investments of the Participant under the Policyholders Fund (excluding ULIP Funds in case of Life Insurers) and the Shareholders Funds taken together. Life Insurers shall normally adhere to the 100% limits based on respective funds i.e. Life and P&A Fund. However, it is noted that in some of the Funds, the book value of the existing investments is lower than the expected premiums on the underwritten insurance contracts. In such circumstances, the Insurer can utilize the exposure limit available in other funds within the overall 100% limit under supervision of the Board. The MTM gain/loss arising out of the effective/ineffective hedge shall be borne by the respective fund only.
- vii) If the reinvestment of maturity proceeds of the existing investments/interest income receivable on investments are hedged, such investments shall be held till maturity. If unavoidable need arises to liquidate instrument to meet the ALM, the hedge on such instrument has to be unwound simultaneously after obtaining specific approval from Investment Committee. IC shall grant such approval after due recording of the reasons.

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- E) Insurers are advised to ensure documentation requirements complete in all aspects as per guidelines of RBI and documentation prescribed by ISDA (International Swaps and Derivative Association). Further, to settle the mark to market profits/losses and maintenance of collateral, suitable two-way CSA (Credit Support Annex) agreements shall be mandatory to mitigate the counterparty risk. CSA is an agreement between counterparties on the types of collateral and posting mechanism. Derivative contract shall be subject to conditions mentioned in Indian laws & Jurisdiction of Indian courts and shall be consistent with Regulations framed in this regard. Suitable clauses should be incorporated to suit the regulatory framework applicable to Insurers. Insurers shall necessarily have power to terminate the contract as and when desired.
- F) Nothing shall be inconsistent with Insurance Act, 1938, IRDA Investment Regulation, 2000, SEBI Regulations, RBI guidelines and any other directions issued by other Regulatory agencies in this regard.
- G) Accounting of Interest Rate Derivatives shall be as per Accounting Standard – 30 as prescribed by ICAI and amended from time to time. The presentation in the financial statements and disclosures are governed by AS 31 and 32 issued by ICAI. In specific, the Insurer have to make the following disclosures in the Financial statements:
1. Description of Participant's financial risk management objective and policies, in particular its policy for hedging forecasted transactions.
  2. Hedging strategy.
  3. Accounting Policy for Derivatives.
  4. Nature and terms of outstanding Interest Rate derivative contracts.
  5. Quantification of the losses which would be incurred if counter-parties failed to fulfil their obligation under the outstanding Interest Rate derivative contracts.

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**H) Internal Risk Management policy and processes, Exposure and Prudential limits:**

Each participant should, before commencement of dealing in Interest Rate derivatives, frame detailed preapproved risk management policy by the Board of Directors. The policy shall cover:

- i) Insurers overall appetite for taking risk and ensure that it is consistent with its strategic objectives, capital strength etc.
- ii) define the approved derivatives products and the authorized derivatives activities.
- iii) provide for sufficient staff resources and other resources to enable the approved derivatives activities to be conducted in a prudent manner;
- iv) ensure appropriate structure and staffing for the key risk control functions;
- v) establish management responsibilities;
- vi) identify the various types of risk faced by the Insurer and establish a clear and comprehensive set of limits to control these;
- vii) establish risk measurement methodologies which are consistent with the nature and scale of the derivatives activities;
- viii) require stress testing of risk positions;
- ix) detail the type and frequency of reports which are to be made to the board (or committees of the board);
- x) applicable VAR limits.
- xi) circumstances for termination and closure of the contract.
- xii) accounting treatment of the proposed derivatives in the company, and
- xiii) solvency/capital impact due to the use of derivatives.

The implementation of the policy is the responsibility of the Investment committee (IC) with an oversight by the Board of Directors. No prior approval of the Authority is needed as required in Form 4 of IRDA (Investment) Regulations, 2000.

**I) Suitability and appropriateness policy:**

The Board shall ensure that the Rupee Interest Rate Derivatives are suitable for the portfolio handled by the Insurer and the liabilities undertaken by the Insurer. The Board shall supervise whether suitability and appropriateness was evaluated by the

market maker in terms of clause 8.3 of guidelines issued by RBI[DBOD No. BP. BC. 86/21.04.157/2006-07 (RBI/2006-2007/333) dated April 20, 2007&DBOD.No.BP.BC. 27/21.04.157/2011-12 (RBI/2011-12/136) dated 2 August, 2011].

**J) Corporate Governance:**

While dealing with such potentially complex products the Board and the senior management of insurer should understand the nature of the risk undertaken, complexities involved, stress levels etc. At periodical intervals (at least once in an year), the Board of Directors shall review the contracts undertaken and satisfy themselves that adequate risk measurement and management policy and procedures for measurement and management of interest rate risk with fixed income derivative contracts permitted in these guidelines, have been established and are functional.

**K) Reporting and Audit**

Quarterly report shall be submitted to the Authority as per **Annexure A**, if the Insurer undertakes any Interest Rate Derivatives. Before trading in Interest Rate Derivatives, the Insurer shall obtain certificate from the Concurrent Auditor stating that the suitable systems and procedures are available and requirements as per these guidelines are met. The concurrent auditor shall also ensure the compliance of the above guidelines and have to comment in their quarterly report submitted to the Authority.

The Auditor of Investment Risk Management Systems & Process shall also comment on the systems and procedures available in their periodical audits.

**The above guidelines are issued under the powers vested in Section 14 (2) of IRDA Act, 1999.**

  
R K NAIR  
MEMBER (F & I)

1) Details of Rupee Interest Rate Derivatives, counter party wise :

Name of the Insurer	
Quarter- Year	

S. No	Name of the Counter-party	Nature of the derivative contract (FRA/IRS/IRF)	Tenor of derivative contract	Notional Amount of the derivative contract	Market (Profit/loss)	Unsettled MTM (Profit/loss)	Nature of underlying	Tenor of the underlying	Face Value of the underlying	Hedge Designation (Cash-flow/Reinvestment/interest receivable)	PV01 of the Underlying being hedged (bps)	PV01 of the derivative (bps)

2) Counterparty-wise Credit Exposure on account of derivative transactions:

S. No.	Counterparty	Notional of derivative contracts O/S	Current Credit Exposure	Potential Future Credit Exposure	Value of Collateral	CSA posting limit	Type of Collateral

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3) Fund wise Notional outstanding derivative transactions and the BV of investments

Fund Name	Notional outstanding derivative transactions	Expected Cash Flows on underwritten Insurance Contracts	BV of investments	Percentage of Notional outstanding on the BV of Investments	Remarks
<b>Total</b>					

4) Benchmark-wise derivative activity during the quarter :

S. No.	Nature of the derivative contract	Benchmark	Notional Amount of derivative contracts O/S at the beginning of the quarter	Fresh derivative contracts/ positions taken during the quarter	Derivative contracts/ positions terminated/ matured/ expired during the quarter	Notional Amount of derivative contracts O/S at the end of the quarter
	FRA	MIBOR/ OIS				
	FRA	INBMK				
	IRS	MIBOR/ OIS				
	IRS	INBMK				
	IRF	GOI				

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