



Republic of the Philippines
Department of Finance
INSURANCE COMMISSION
1071 United Nations Avenue
Manila

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CIRCULAR LETTER

**TO : ALL INSURANCE/REINSURANCE COMPANIES
AUTHORIZED TO TRANSACT BUSINESS IN THE
PHILIPPINES**

**SUBJECT : REGULATIONS GOVERNING INVESTMENTS IN
DERIVATIVES AND LIMITING THE SAME TO CONTRACTS IN
THE FORM OF FORWARDS AND SWAPS**

Pursuant to the powers of the Insurance Commissioner under Sections 202 (k)¹ and 437 of the Amended Insurance Code and to manage financial risks through hedging and promoting investment diversification, the following guidelines for derivative activities limited to forwards and swaps only may be allowed with prior approval from this Commission:

1. **Definition of Terms.** – the following terms shall have the respective meanings hereinafter set forth or indicated, unless the context otherwise requires:
 - a. **Derivative** – a financial instrument that primarily derives its value from the performance of an underlying variable²; a financial instrument that derives its value from the movement in commodity price, foreign exchange rate and interest rate of an underlying asset or financial instrument³;
 - b. **Hedging** – a risk management strategy used in limiting or offsetting probability of loss from fluctuations in the prices of commodities, currencies, or securities⁴;

¹ Sec. 202 (k) Other assets, not inconsistent with the provisions of paragraphs (a) to (j) hereof, which are deemed by the Commissioner to be readily realizable and available for the payment of losses and claims at values to be determined by him in a circular, rule or regulation.

² BSP Circular Letter No. 594 Series of 2008 dated January 8, 2008

³ Financial Accounting 2011 Ed.

⁴ BusinessDictionary.com

c. **Forward Contract/Agreement⁵** –

- i. Forward Foreign Exchange (FX) Contracts - refers to an agreement for delayed delivery of a foreign currency in which the buyer agrees to purchase and the seller agrees to deliver at a specified future date a specified amount at a specified exchange rate;
- ii. Bond Forwards – refers to a forward bond contract where the seller agrees to deliver a specific bond to the buyer at a set price and at a certain future date.

d. **Swap Agreement⁶** -

- i. FX Swaps – refers to an agreement involving an initial exchange of two currencies, usually at the prevailing spot rate, and a simultaneous commitment to reverse the exchange of the same two currencies at a date further in the future at a rate (different from the rate applied to the initial exchange) agreed on a deal date;
 - ii. Interest Rate Swaps – refers to an agreement in which the parties agree to exchange interest cash flows on a principal amount at certain times in the future according to an agreed formula;
 - iii. Currency Swaps – refers to an arrangement in which two parties exchange a series of cash flows in one currency for a series of cash flows in another currency, at a specified exchange and/or interest rate and at agreed intervals over an agreed period.
- e. **International Swaps & Derivatives Association, Inc. (ISDA)** – the trade organization of participants in the market for over-the-counter derivatives that has created a standardized contract (ISDA Master Agreement) to enter into derivatives transactions;
- f. **Master Agreement** – a document agreed into by and between two parties that sets out standard terms that apply to all the transactions entered into between those parties. Each time that a transaction is entered into, the terms of the master agreement do not need to be re-negotiated and hence, apply automatically;
- g. **ISDA Master Agreement** – the most commonly used master service agreement for over-the-counter derivative transactions internationally;
- h. **Market Counterparty** – refers to any Universal Bank (UB) or Commercial Bank (KB), only with respect to the instruments for which it is authorized to engage in as a dealer.

⁵ BSP Circular Letter No. 594 Series of 2008 dated January 8, 2008

⁶ Ibid.

2. **Qualification.** – Only those insurance/reinsurance companies with a networth of Five Hundred Fifty Million Pesos (Php550,000,000.00) or more may engage in derivative activities. In addition, the following requirements shall be complied with:
 - a. An insurance/reinsurance company can only engage in derivative activities with a Market Counterparty authorized by the Bangko Sentral ng Pilipinas (BSP) as dealers;
 - b. Understands, measures and is able to prudently manage the risk associated with derivative activities;
 - c. Clearly defines its objectives, ensuring that such transaction is in accordance with Philippine Accounting Standards (PAS) and with the applicable provisions of the Amended Insurance Code; and
 - d. Adequate risk management system and internal controls to cover the risks is already in place.
3. **Limitation on Derivative Activities.** - A qualified insurance/reinsurance company will be allowed to engage in derivative activities limited to forward and swap agreements as defined under Section 1 of this Circular; Provided, that at any given time, the aggregate placements in derivatives does not exceed ten percent (10%) of the total admitted assets of the life insurance company or twenty percent (20%) of networth of a non-life insurance/reinsurance company.
4. **Prior approval of the Commission.** – Before any insurance/reinsurance company engages in derivative activities, the following documents shall be submitted:
 - a. Written request for approval stating the objectives in entering into derivative activities and proof that it understands and will be able to manage the risks associated with derivative activities;
 - b. Duly accomplished questionnaire from the Insurance Commission to verify and evaluate the capability of the applicant company to engage in derivative activities. Attached as **Annex A** is the questionnaire; and
 - c. Standardized legal bilateral documents in the form of the ISDA Master Agreement and the Credit Support Annex (CSA), if applicable. Assets posted as collateral under the CSA shall be considered as admitted assets.
5. **Compliance.** – For the purpose of monitoring compliance with these guidelines and evaluating the performance of the derivative instrument, every insurance/reinsurance company authorized by this Commission to engage in derivative activities shall submit to the Investment Services Division of this Commission a monthly report on derivative transaction/s with the Market Counterparty every 15th day of the month. Attached as **Annex B** is the monthly report format.

6. **Accounting Guidelines.** – The recording of transactions shall be in accordance with the Philippine Accounting Standards (PAS) and with the applicable provisions of the Amended Insurance Code.
7. All other pertinent provisions of the Amended Insurance Code shall, likewise, be applicable and the provisions of this Circular shall be without prejudice to other requirements that the Commission may deem necessary.

For strict compliance.



EMMANUEL F. DOOC
Insurance Commissioner

Encl.:a/s

ANNEX A

QUESTIONNAIRE

Please answer clearly and truthfully:

1. What is the proposed transaction?
2. Which bank is your counterparty for this **hedge transaction**? Is it a universal bank or commercial bank? What specific Derivatives Authority has been granted by the Bangko Sentral ng Pilipinas (BSP)?
3. Was the bank able to adequately describe the product so the benefits and risks are completely understood by your insurance company?
4. What specific circumstances or facts caused your company to enter the above transaction?
5. Does your company have a Risk Management Policy approved by the Board of Directors that covers the following:
 - The purpose for which derivatives may be used;
 - The nature/types of allowed derivatives;
 - Procedures for authorizing/approving, monitoring and reporting your company's derivative activities; and
 - Procedure for evaluating the creditworthiness of the counterparties.
6. What is the experience of your company in dealing with similar products?
7. Is your company able to account for the product according to Philippine Accounting Standards?
8. Has the Board of Directors approved the specific transaction or made a resolution approving hedging and delegating a key decision maker authority to execute the transaction? Has the product or transaction been presented to the key decision maker? If so, who is the key decision maker? Are the necessary internal approvals in place to enter the transaction?
9. Can the key decision makers demonstrate that they understand the product or structure and its potential financial outcomes?
10. Please provide an electronic or written confirmation that based on the suitability guidelines of the counterparty bank, the transaction proposed is suitable for the insurance company.

ANNEX B

MONTHLY REPORTING

New Derivatives

Derivative Description	Asset to Hedge	Notional Amount	Start Date	Maturity Date	Counterparty

Outstanding Derivatives

Derivative	Asset to Hedge	Notional Amount	Start Date	Maturity Date	Counterparty	Market Value

Matured Derivatives

Derivative Description	Asset to Hedge	Notional Amount	Start Date	Maturity Date	Counterparty