

Content

Title :	Regulations Governing Derivatives Transactions Conducted by Insurance Companies <b>Ch</b>
Date :	2014.12.24
Legislative :	Amended on 24 December 2014 per Order Ref. Jin-Kuan-Bao-Tsai 10302509851 of the Financial Supervisory Commission.
Content :	<p>Article 1 These Regulations are formulated in accordance with the provisions of Paragraph 8 of Article 146 of the Insurance Act (hereinafter referred to as the "Act").</p> <p>Article 2 The terms used in the Regulations are defined as follows:</p> <ol style="list-style-type: none"><li>1. "Derivatives transactions" mean "transactions for hedging purpose", "transactions for enhancing the investment efficiency", or "transactions of structured products".</li><li>2. "Transactions for hedging purpose" mean derivatives transactions which comply with the following provisions:<ol style="list-style-type: none"><li>(1) The hedged item is in existence and exposes the insurance company ("insurer") to identifiable risk of loss;</li><li>(2) The hedging derivatives transactions may reduce the risk of the hedged item and are specified for hedging the aforesaid item; and</li><li>(3) When conducting the hedging transactions, where the underlying instrument of the hedging derivatives is different from the hedged item, such instrument and the hedged item shall be specified in a formal document, with a statement certifying the high correlation between them.</li></ol></li><li>3. "A hedged item" means an existing investment position or an anticipated investment position. An anticipated investment position, in particular, can include the following:<ol style="list-style-type: none"><li>(1) An anticipated reinvestment position of the principal of an existing investment position that will reach maturity within the coming year and the incurred interest;</li><li>(2) An anticipated investment position of cash flow expected to go on within the coming year from sold insurance policies.</li></ol></li><li>4. "Risk of a hedged item" means the price, interest rate, exchange rate, and credit, among other things, of the hedged item.</li><li>5. "High correlativity" means that with all the transaction records of the past three months or more as samples, the correlation coefficient with regard to the rate-of-change of price or rate of return between the underlying instrument of the hedging derivatives or the portfolio thereof is equivalent to 70% or above.</li><li>6. "Transactions for enhancing the investment efficiency" mean those with purposes other than hedging and investing in structured products.</li><li>7. "Value-at-risk calculation of positions relevant to transactions for enhancing the investment efficiency" means that 10-day 99% VAR for the above position is required to be calculated either on a weekly basis for at</li></ol>

least three years period or on a daily basis for at least one year period. On top of that, the aforesaid data shall be updated on a weekly basis and back testing of the above VAR shall be performed on a monthly basis.

8. "Transactions of structured products" mean transactions of portfolios combining fixed-income instruments and derivatives issued or guaranteed by financial institutions.

9. "Aggregate nominal value" means the value calculated in accordance with the following requirements:

(1) In option contracts, it is the sum of products of the exercise price multiplied by the theoretical hedging ratio and the total number of open-interest positions.

(2) In interest rate swap contracts, it is the sum of products of the nominal principal of hedged item multiplied by the theoretical hedging ratio.

(3) In leveraged derivatives contracts, it is the sum of products of the nominal principal in the contract multiplied by the leverage.

(4) For derivative contracts other than those mentioned in the preceding three items, it is the sum of the contract value or the nominal principal.

10. "Foreign credit rating agencies" mean Moody's Investors Service, Standard & Poor's Corp. and Fitch Ratings Ltd.

#### Article 3

An insurer which intends to engage in the derivatives transactions for hedging purpose with hedged items being existing investment positions, shall submit an application together with the following documents to the competent authority for prior approval:

1. Statement of law compliance;
2. Documents of authorization by the board of directors (governors) or other proper personnel;
3. Documents of proving that the personnel in charge of the aforementioned derivatives transactions have relevant working experience or specialized training;
4. Procedures for processing derivatives transactions; and
5. Important policies and procedures governing derivatives transactions and risk management.

Any addition or change to the documents specified in Subparagraphs 2 to 5 of the preceding Paragraph shall be reported to the competent authority for reference purpose.

#### Article 4

An insurer meeting the following eligibility criteria and approved by the competent authority in accordance with the requirements of Paragraph 2 may engage in derivative transactions for hedging purposes with hedged items being anticipated investment positions:

1. Eligibility criteria indicated in Article 5 Paragraph 1; and
2. Approval from the competent authority in accordance with the requirements in Article 5 Paragraph 2 for engaging in derivatives transactions for enhancing the investment efficiency.

When an insurer intends to engage in the derivatives transactions for hedging purposes with hedged items being anticipated investment positions, approval of the board of directors shall be obtained and the application form along with the following documents shall be submitted in advance to

the competent authority for approval:

1. Supporting documents for meeting the eligibility criteria in the preceding paragraph;
2. Documents listed in Article 3 Paragraph 1 ; and
3. Descriptions of the levels of influence of the following different factors on hedging effectiveness that can be specifically distinguished using the mathematical method for calculating the hedging effectiveness:
  - (1) Influence of expected differences in the execution of portfolio asset allocation plans indicated in Paragraph 3 Subparagraph 1; and
  - (2) Other factors than those indicated in the preceding item.

An insurer approved by the competent authority to engage in derivatives transactions for hedging purposes in accordance with the requirements in the preceding paragraph shall follow the requirements below:

1. It shall detail specific asset allocation plans for the expected portfolio and analysis of hedging effectiveness in official written documents before transactions; the said analysis of hedging effectiveness shall be reviewed by a risk management unit independent of the transaction department.
2. When the hedging effectiveness obtained for the expected portfolio differs from that for the actual portfolio by 20% or more, as a result of the difference in the implementation of the asset allocation plan for the expected portfolio as mentioned in the preceding subparagraph, the value of transactions for the effective periods of respective transactions shall be included as part of the limits for derivatives transactions for enhancing the investment efficiency.

#### Article 5

An insurer with the following qualifications and get approved from the competent authority may engage in the derivatives transactions for enhancing the investment efficiency:

1. The insurer's risk-based capital ratio is equivalent to 250% or above;
2. The value-at-risk calculation is performed every day to measure and manage the risk exposure of derivatives positions;
3. In the immediately preceding year, there are no major violations of performing the insurer's internal control procedure with regard to the use of funds, or the rectification of such violations have been done and get affirmed by the competent authorities;
4. Having not been subject to major sanction/penalty or cumulative fines of more than NTD 3 million by the competent authority in the immediately preceding year, or the rectification of such violations have been done and get affirmed by the competent authorities; and
5. Other eligible qualifications required by the competent authority.

An insurer intending to engage in the derivatives transactions for enhancing the investment efficiency shall submit the trading proposal which has got approved by the board of directors, together with the application form and the documents in support of the qualification provided in the first Paragraph of this article to the competent authority for getting a prior approval. The trading proposal shall record forth the following information:

1. Types of derivatives;
2. Restrictions on manipulation of derivatives;

3. The objects of investment efficiency enhancement and the way to assess its performance;
4. Mechanism with regard to risk-limit management, including the limit on total position, stop-loss strategies and the frequency of assessment etc. Where the trading proposal mentioned in the preceding Paragraph is amended and get approved by the board of directors, it shall be submitted to the competent authority for reference purpose after it.

#### Article 6

An insurer may engage in the following derivatives transactions relating to investment in domestic securities specified in Article 146-1 or loans in Article 146-3 of the Act for hedging purposes:

1. Call (put) warrants traded by Taiwan Stock Exchange Corporation or GreTai Securities Market;
2. Futures trading contracts traded on Taiwan Futures Exchange Corporation (TFEC) and futures trading contracts traded on foreign exchanges through collaboration agreements entered into by TFEC and foreign exchanges;
3. Such derivatives referencing to various underlying instruments besides those in the preceding two subparagraphs which domestic and foreign financial institutions meeting the following requirements are permitted to trade with or for customers according to law:
  - (1) Domestic financial institutions with their risk-based capital ratio, ratio of regulatory capital to risk-weighted assets, regulatory capital adequacy ratio, or the percentage accounted for by adjusted net capital in the total amount of customer margins required for the open positions of futures traders meeting regulatory criteria.
  - (2) Foreign financial institutions with BBB+ equivalent or above credit rating suggested by foreign credit rating agencies in the immediately preceding year.

#### Article 7

An insurer may engage in the following derivatives transactions relating to investment in foreign securities specified in Article 146-4 of the Act for hedging purposes:

1. Foreign futures trading, in which the futures commission merchants are entitled to engage, as is announced by the competent authority according to Article 5 of the Futures Trading Act;
2. Such derivatives referencing to various underlying instruments besides those in the preceding subparagraphs which domestic and foreign financial institutions meeting the requirements in Article 6 Subparagraph 3 are permitted to trade with or for customers according to law.

#### Article 8

An insurer may engage in the following derivatives transactions for enhancing the investment efficiency:

1. Call (put) warrants traded on Taiwan Stock Exchange Corporation or GreTai Securities Market;
2. Futures trading, in which the futures commission merchants are entitled to engage, as is announced by the competent authority according to Article 5 of the Futures Trading Act;
3. The sale of call options and transaction of swaption on the over-the-counter markets with domestic financial institutions and branches of foreign financial institutions meeting the requirements in Article 6

Subparagraph 3 by the insurer which actually holds the spot financial instruments specifically corresponding to the underlying instruments of such options.

#### Article 9

The limits on the derivatives transactions for hedging purpose or enhancing the investment efficiency are listed below:

1. Where the derivatives are held for hedging purpose, the aggregate nominal value of the contracts thereof shall comply with the following provisions:

(1) When hedged items are existing investment positions, this may not exceed the aggregate book value of the hedged items.

(2) When hedged items are anticipated investment positions, this may not exceed the total value of the hedged items.

2. Where the domestic or overseas derivatives are held for enhancing the investment efficiency, the aggregate nominal values of the contracts thereof shall not exceed 5% of the insurer's funds, among which the overseas position shall not exceed 3% of the insurer's funds. The aforesaid overseas derivatives shall be restricted to those derived from the overseas financial commodities only and without any derivatives transactions which based on the domestic securities, combination of securities, interest rates, exchange rates or indices involved in.

3. Where the derivatives are held for enhancing the investment efficiency and linked to the equity of single company, the aggregate nominal values of the contracts thereof shall not exceed 0.5% of the insurer's funds.

Where the following conditions are satisfied, the aggregate nominal values of the open long contracts and the open short contracts, held either for hedging purpose or for enhancing the investment efficiency as mentioned in the preceding paragraph, are allowed to be offset:

1. The derivatives are the futures or options derived from the same interest rates, securities, indices, or exchange traded funds.

2. The derivatives are derived from the interest rates highly correlated to price change or the interest rate swaps, futures or options of fixed-income securities as are highly correlative in terms of the price fluctuations thereof, and no physical settlement shall be involved.

#### Article 10

An insurer may engage in forwards, currency swaps, cross currency swaps and other exchange rate hedging transactions among currencies related investment items established in Article 146-4 of the Act and Regulations Governing Foreign Investments by Insurance Companies for hedging purposes and the aggregate nominal value of such contracts may not be included as part of the ceiling value indicted in the preceding article.

#### Article 11

Structured products fulfilled with the following conditions are allowed to be invested by an insurer which intends to engage in transactions of structured products and the aggregate amount of such investment shall not exceed 10% of the insurer's funds:

1. The final maturity date shall be no longer than 10 years;

2. The principal-guaranteed rate on the maturity date shall be 90% equivalent or above provided that the final maturity date is no longer than

5 years, or the aforesaid principal-guaranteed rate shall be 100%;

3. The operational risk relating to the underlying derivatives instruments shall be borne by the issuing institutions.

The issuing or guarantee institutions of the aforesaid structured products shall be the domestic and foreign financial institutions meeting the requirements in Article 6 Subparagraph 3 and permitted to trade such structured products with or for customers according to law.

#### Article 12

When engages in derivatives transactions, the formulation and alteration of the processing procedure shall all be subject to the approval of the board of directors.

#### Article 13

The following information shall be involved in the processing procedure for derivatives transactions, and the formation and alteration of the abovementioned procedure shall be carried out with auditors, senior executives of legal compliance and risk management agencies as well as relevant supervisors involved in:

1. Transaction principles and policies, including the types of derivatives transactions, major counterparties, hedging or investment strategies, overall and individual position limits;
2. Operational procedure, including the responsible management level, department in charge, authority limits, division of powers and duties and transaction procedure;
3. Internal control system, including the risk identification and assessment, assessment of legality, operation and management rules and regulations, transaction record keeping procedure, assessment method and frequency, irregularity reporting system;
4. Internal audit system, including internal audit framework, audit frequency, audit scope, audit report submission procedure and follow-up of improvement of deficiencies;
5. Accounting system, including book keeping and entry processing procedure, recognition of profit and loss, and disclosures in financial statement;
6. Risk management system, which shall include the identification, assessment, monitoring and reporting of transaction risks which shall at least include credit, market, liquidity, operational, legal and system risks.
7. Counterparty risk, which requires that when conducting over-the-counter transactions, the insurer shall perform credit risk assessment on the counterparties and assign to individual counterparties different transaction limits according to their credit positions, and the transaction limits shall be subject to constant monitoring; and
8. The items must be reported to the board of directors and risk management committee on a regular basis as indicated in Paragraph 2.

An insurer shall at a minimum report to the board of directors and the risk management committee on a regular basis as follows:

1. Items to be reported:

- (1) Total and net amount of contracts with the obligations which have not become due as well as unrealized gain or loss evaluated in accordance with the fair value;

- (2) Compliance with the Procedure for Derivatives Transactions;
- (3) Performance and risk assessment reports on the transactions for hedging or for enhancing the investment efficiency.
- (4) When a hedged item is anticipated investment position and the hedging effectiveness obtained for the expected portfolio differs from that for the actual portfolio by 20% or more, differences in and reasons for the hedging effectiveness as mentioned above shall be reported.

2. Reporting frequency:

- (1) Reports about transactions for hedging purpose and transactions of structured products must be made to the board of directors and the risk management committee at least once every six months.
- (2) Reports about transactions for enhancing the investment efficiency must be made to the risk management committee and the board of directors or its authorized unit at least once a month. However, when the following conditions are met, reports to the board of directors and the risk management committee can be made on a quarterly basis:
  - (i) Immature transactions are engaged in pursuant to Article 8 and internal insurance company database is available to store related transaction information.
  - (ii) The sum of realized and unrealized losses for the effective period of any transaction in (i) does not exceed NTD50 million or 0.1% of the insurer's stockholder's equity, whichever is lower.
  - (iii) The sum of realized and unrealized losses for the effective periods of all transactions in (i) does not exceed NTD100 million or 0.2% of the insurer's stockholder's equity, whichever is lower.

Article 14

The board of directors of the insurer shall ratify the important policies and procedures concerning the derivatives transactions and risk management and perform review thereof at least annually, and shall appoint a senior executive to take responsibility to administer the derivatives transactions in accordance with the following principles:

1. The fulfilment of both the procedure for derivatives transactions and the regular review of the appropriateness thereof are actually being executed;
2. The appointment of the dealers, the authorization of each dealer's limits and the identification of each dealer's knowledge or professional training is sufficient enough are essentially his/her duties;
3. The identification of each accounting personnel's and internal auditor's knowledge or professional training is sufficient enough is essentially his/her duty;
4. The supervision of transaction performance and the in-time reports to the board of directors concerning the abnormal profit and loss are carried out dutifully;
5. The assessment of the positions of the derivatives, as well as the evaluation of whether the performance is in keeping with the preset strategies for hedging or enhancing the investment efficiency and whether the risk exposure may undermine the financial soundness of the company performance are implemented on a monthly basis;
6. For transactions for enhancing the investment efficiency, the performance evaluation reports shall be compiled on a daily basis in

accordance with the fair value and reported to the chairman, general manager, and the highest ranking supervisor of risk management. However, when criteria established under the proviso in Paragraph 2 Subparagraph 2 Item 2 of the preceding article are met, compilation and reporting shall be done at least on a monthly basis.

#### Article 15

The following principles concerning the risk management of derivatives transactions by the insurer shall be obediently fulfilled:

1. An risk management department independent of the dealing department shall be established, and the personnel responsible for the risk management of derivatives transactions shall possess the professional competence in risk identification, assessment, monitoring and reporting and shall not hold any concurrent posts in the derivatives dealing department;
2. The functions of dealing, confirmation and settlement of derivatives transactions shall be performed by different personnel;
3. The risk-bearing capacity of the insurer's funds shall be taken into consideration when determining the risk management limits; and
4. The value of derivatives and the return thereof shall be assessed at fair market prices, and risk measuring methods shall be designed therefor.

#### Article 16

The audit department of the insurer shall perform the following duties and prepare a quarterly audit report which shall be passed by the board of directors and submitted to the competent authority for reference:

1. To audit the compliance of the processing procedure for Derivatives Transactions as well as the relevant laws and regulations;
2. To audit the internal control measures, including the functions of internal checks and cross reference;
3. To assess the independence of the risk management operations and implementation of the risk limitation measures;
4. To verify the reliability of the sources of transaction documents and information; and
5. To audit the hedging effectiveness of transactions for hedging purpose and differences between hedging effectiveness obtained for the expected portfolio and that for the actual portfolio.

#### Article 17

This Regulation shall come into force on the date of promulgation.