IRDA draft permits insurers to deal with financial derivatives with 10 yrs' tenure

Insurance Regulatory and Development Authority (IRDA) has proposed to permit insurance companies to deal with financial derivatives with 10 years duration. As per existent rules, insurers are permitted to enter Forward Rate Agreements (FRAs), Interest Rate Swaps (IRS) and Exchange Traded Interest Rate Futures with a maximum tenure of one year.

Companies enter into these agreements to hedge the interest rate risk on investments and the forecasted transactions. Hedging interest rate risk of investment in fixed income securities would cover fixed income derivative positions that are designed to offset the potential losses from existing fixed income investments of them.

Hedging for forecasted transactions would cover positions in fixed income derivative contracts that are designed to mitigate projected loss due to probable change in interest rates on investment of policy premium income receivable for 10 years. It would also include positions on homogeneous group of assets and liabilities, provided the assets and liabilities are individually permitted to be hedged for a term of 10 years.

Irda has said that an insurer dealing in fixed income derivatives under these guidelines shall in aggregate not exceed an outstanding notional principal amount equivalent to 100 per cent of the book value of the fixed income investments of the insurer under the Policyholders Fund and Shareholders Fund taken together.

The insurance regulator, in the draft, said that there was a need to review the old guidelines in view of the changes in investment environment, product structures and changes in guidelines by Reserve Bank of India (RBI), which is the sectoral regulator. Further, insurers had also made representations to permit them to hedge interest rate risks with longer term financial derivatives.

The Irda draft has said that no contracts should be entered with promoter group entities either directly or indirectly. “Further, exposure to derivative instruments with underlying infrastructure instruments shall be treated as exposure to infrastructure norms,” it said. It has added that to settle the mark to market profit/losses and maintenance of collateral, suitable Credit Support Annex (CSA) agreements shall be mandatory to mitigate counterparty risk. CSA is an agreement between counterparties on the types of collateral and posting mechanism.

Insurers have been asked to submit a quarterly report to Irda if they undertake any Rupee Interest Derivatives. The stakeholders have been given 30 days to present their views on the draft.

(Business Standard)