

Report on the Possibility for Insurance Companies to Use Hedge Funds¹

December 2005

1. Introduction

The purpose of this survey is to gather information at Community level on the different arrangements regulating the possibility for insurance companies to use hedge funds. This is a topical issue given the increasing interest by institutional investors in this type of alternative product.

The following countries took part in the study²: Austria, Belgium, France, Germany, Denmark, Estonia, Spain, Hungary, Ireland, Iceland, Italy, Lithuania, Luxembourg, Latvia, Malta, the Netherlands, Norway, Poland, Portugal, Sweden, Slovenia, Slovakia and the United Kingdom.

The survey starts with a brief introduction of the rules which – in each Member State – implement and supplement Community regulations on investments covering technical provisions, limited to the investment in units in *Undertakings for Collective Investment in Transferable Securities* (UCITS) and other investment funds.

Then it goes on to analyse whether each Member State permits hedge funds as investments covering technical provisions. In this regard close attention is focussed on the specific rules applied by national legislations, on the restrictions on the amount of investments in hedge funds and on any other conditions undertakings must comply with when investing in alternative funds.

Finally this survey deals with the possibility (where admitted) to directly or indirectly link the benefits and surrender value of a life assurance contract to the value of the units in hedge funds or of structured products linked to hedge funds.

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Community directives 2002/83/EC on life assurance (art. 23) and 92/49/EEC on non-life insurance (art. 21) provide for categories of assets admissible as cover for technical provisions. Not all the assets included in said categories are automatically authorised in each Member State. In fact under the directives each national legislator has the option of establishing more detailed rules in relation to individual assets included in the acceptable categories.

¹ Parts of this document are a simplification of the legal contexts. For a full and more accurate picture of the regulation in the different Member States individual national legislations may have to be consulted.

² The report was prepared by the Italian Delegation.

Among admitted categories there are units in UCITS and other investment funds. The regulations on investments in this category of assets vary between Member States.

Most countries subdivide UCITS into subcategories, and envisage different qualitative/quantitative limits to their use. In some cases they are subdivided according to their harmonisation with Community regulations and/or the authorisation to their marketing on the national territory; in others, according to the geographic residence of the issuers, and in others according to their use, by distinguishing – for instance – between those used in relation to contracts where the risk is borne by the policyholder and those where the risk is borne by the undertaking.

Some countries (DE, NL, IE, SE and UK) have adopted the “look through” approach. According to this principle all UCITS – irrespective of the type – investing in assets, which are, in turn, accepted as cover for technical provisions, are accepted. Sometimes quantitative limits have been established.

Other countries (BE, LU and PT) apply a limit on investments, based on the distinction between investments to be used as cover for technical provisions pertaining to unit-linked contracts or for other types of technical provisions. In addition there are also minimum thresholds for investments in individual funds or general limits concerning the total amount of investments.

2. Hedge funds as a category of assets representing technical provisions

The European directives do not make any mention of hedge funds as a category of assets accepted as cover for technical provisions. The absence of a specific rule at Community level has led to the implementation of various and different regulations on the possible use of such instruments at the level of the individual Member States (see fig. 1).

Figure 1 – Admissibility of hedge funds as cover for technical provisions

Y	N
Austria	
Belgium	
Denmark	
Germany	
Iceland	
Ireland	
Latvia	
Luxembourg	Estonia
Malta	France
Netherlands	Hungary
Norway	Italy
Poland	Lithuania
Portugal	Slovakia
Sweden	Slovenia
United Kingdom	Spain

- Some countries (EE, ES, FR, HU, IT, LT, SI and SK) prohibit their use because of the risks connected with these forms of investment which, as is well known, often imply the use of derivatives for speculative purposes (which is prohibited by insurance directives).
- Other countries (AT, BE, DE, DK, IE, MT, NL, NO, PL, PT, SE and UK) do not apply specific rules on hedge funds, but if a hedge fund satisfies its rules it is admitted. In these countries these rules apply:
 - o quantitative limits, with maximum limits of investment in individual funds and in total amount vis-à-vis the total representative assets. Some of these countries do not envisage any quantitative limit if assets are used as cover for technical provisions pertaining to contracts where the investment risk is borne by the policyholder. Others prohibit their use in relation to assets where the investment risk is borne by the policyholder (item D - art. 15 Council Directive 91/674 EEC);
 - o qualitative limits, in line with the "look through" approach, which provides for the use of only those hedge funds which invest in assets admissible for covering technical provisions, or which use derivatives exclusively insofar as they reduce the investment risk or facilitate efficient portfolio management.
- Others accept them only as cover for technical provisions linked to contracts where the policyholder bears the investment risk (IS, LV and LU).

In general, the States which admit some hedge funds representing technical provisions require that undertakings have in place management structures with suitable experience and adequate internal accounting and control systems for policyholders' protection. Not all countries require that hedge funds (or funds of hedge funds) be authorised and supervised by a supervisory authority. Furthermore, at Community level there is no homogeneity about the possible use of financial leverage or of retail selling.



The following gives detailed information about the countries which do not prohibit the use of hedge funds as assets accepted as cover for technical provisions:

Austria classifies UCITS and other investment funds into equity funds, fixed income funds, units in real estate funds or equity and debt security funds; the latter are subdivided into sections reflecting risk profiles of the assets in which they invest. For investments in hedge funds and funds of hedge funds regulations envisage an overall investment limit of 7% of technical provisions and an investment limit of 1% in one single hedge fund. An issuer limit of 5% is also envisaged; it can be extended up to 10% for some asset groups.

Belgium, Denmark and Ireland do not explicitly prohibit the possibility for undertakings to invest in hedge funds. These are admitted as UCITS within the limits envisaged by Community regulations; e.g. there is a 10% limit for unlisted instruments (shares, other securities treated as shares and debt securities) which are not dealt in on a regulated market. Denmark sets a further 2% limit per single hedge fund, and envisages stress tests aimed to define further limits on the overall exposure in hedge funds.

Similarly, the Netherlands and Poland do not consider hedge funds as a separate category of assets, and it is up to each insurer to determine whether an investment matches with the insurance liabilities incurred and with regulations. In Poland there are also maximum limits for the investment of assets representing technical provisions in open-ended funds (40%), close-ended funds (10%), and an additional 5% limit in securities of the one issuer (or a group of issuers affiliated).

Regulations in Germany are more detailed, since they are inspired by a “look through” approach. According to this approach, if the structure of the UCITS is transparent all its components will be accounted for in the “relevant limits” of the respective categories of investment. On the other hand, investments in “not transparent” funds are considered separately and account for the entire value up to a maximum 35% envisaged by regulations on assets representing technical provisions in case of investment in shares. Furthermore, in case the funds use financial derivatives, the potential increase in market risk must be calculated within said 35% total limit. With special regard to hedge funds, their use is accepted for the purpose of asset diversification, with a maximum limit of investment of 5%. It is allowed to invest in open hedge funds or funds of hedge funds whose issuers are domiciled within the European Community, with no limit on the minimum number of participants or minimum amount of initial subscription. Moreover, German regulations on hedge funds draw a distinction between “funds with additional risk” (single hedge funds), for which neither minimum ratings nor other limits on the use of financial leverage and short sale are envisaged, and “funds of funds with additional risk”, for which these activities are prohibited. Single hedge funds may not be publicly distributed, and only private placement is admitted. The determination of unit prices and the redemption of units must be calculated not less than every three months; the return of units of single hedge funds must be declared within 40 days before the redemption date (100 days in case of funds of hedge funds).

Malta envisages general limits for UCITS and other investment funds including hedge funds; for unlisted ones the limit for one single fund is 1%, with an overall limit of 15%; for listed ones the limit for one single fund is 15%.

Portugal considers both harmonised and a maximum 5% non-harmonised UCITS admissible as cover for life and non-life technical provisions (excluding those where the investment risk is borne by policyholders). In exceptional cases the Portuguese supervisory authority may authorize, upon a duly founded request by the insurance undertaking, that the units in specific non-harmonised funds should not be considered within the limit of 5%. As a general rule undertakings must prove that such funds are liquid, have non-speculative purposes and that their administration is carried out on the basis of principles of transparency and good management that include, in particular, suitable mechanisms for internal control. Non-harmonised funds must guarantee observance of the principles of diversification and dispersion of risks envisaged for harmonised funds, and they must be authorised on the basis of supervisory rules similar to those used for harmonised UCITS registered in Portugal. Funds are subject to annual audit, while their value must be calculated at least every month. Portuguese legislation considers hedge funds as non-harmonised UCITS, and as such they are admitted as cover for technical provisions up to 5%. No limit is envisaged, apart from that of liquidity, for hedge funds used as cover for technical provisions of contracts where the risk is borne by policyholders.

For the United Kingdom and Sweden the units in investment funds accepted as cover for technical provisions are those in UCITS schemes, non-UCITS retail schemes (in UK also recognised schemes are accepted) and any other collective investment scheme that invests only in admissible assets (“look through” principle). If the schemes invest in derivatives the latter need to be approved in accordance with the specific insurance regulations (for hedging purposes or efficient portfolio management). In the United Kingdom authorised UCITS are admitted without limits, Non-UCITS retail schemes and recognised schemes for each issuer are subject to an individual counterparty limit of 5% of assets representing gross technical provisions. Other collective investment schemes for an issuer are included with other assets it issues that are not dealt in on a regulated market and are subject to a limit of 1% of assets representing gross technical provisions. This last category is subject to a 10% limit across all issuers. According to these regulations the possibility of using units of hedge funds or structured products linked to them as cover for technical provisions is very limited, though it is not explicitly prohibited. This is especially so since structured products often resort to financial leverage or use of derivatives for speculative purposes.

In Norway no specific rules which explicitly mention, allow, or forbid investments in hedge funds are applied. Nonetheless, investments in hedge funds or in structured products related to hedge funds are allowed only if they meet the requirements foreseen in the general rules on investments, especially those concerning the use of derivatives. Moreover, Norwegian legislation emphasises the role and the responsibilities of the board of directors and the management concerning the use of derivatives and the follow up of such activities. Hedge funds are considered as “alternative investments” and they can be used to cover technical provisions up to 5% limit and only if they are realisable within a short time horizon.

Luxembourg, Iceland and Latvia accept investments in units of hedge funds, only if the latter are used in relation to unit-linked contracts. In Luxembourg funds must be authorised and subject to the control of an insurance supervisor. Funds must be quoted and the value of their units must be determined at least on a monthly basis (a quarterly basis for single hedge funds which are only accessible for contracts with premiums higher than 250,000 euro).

3. Hedge funds and company’s free assets

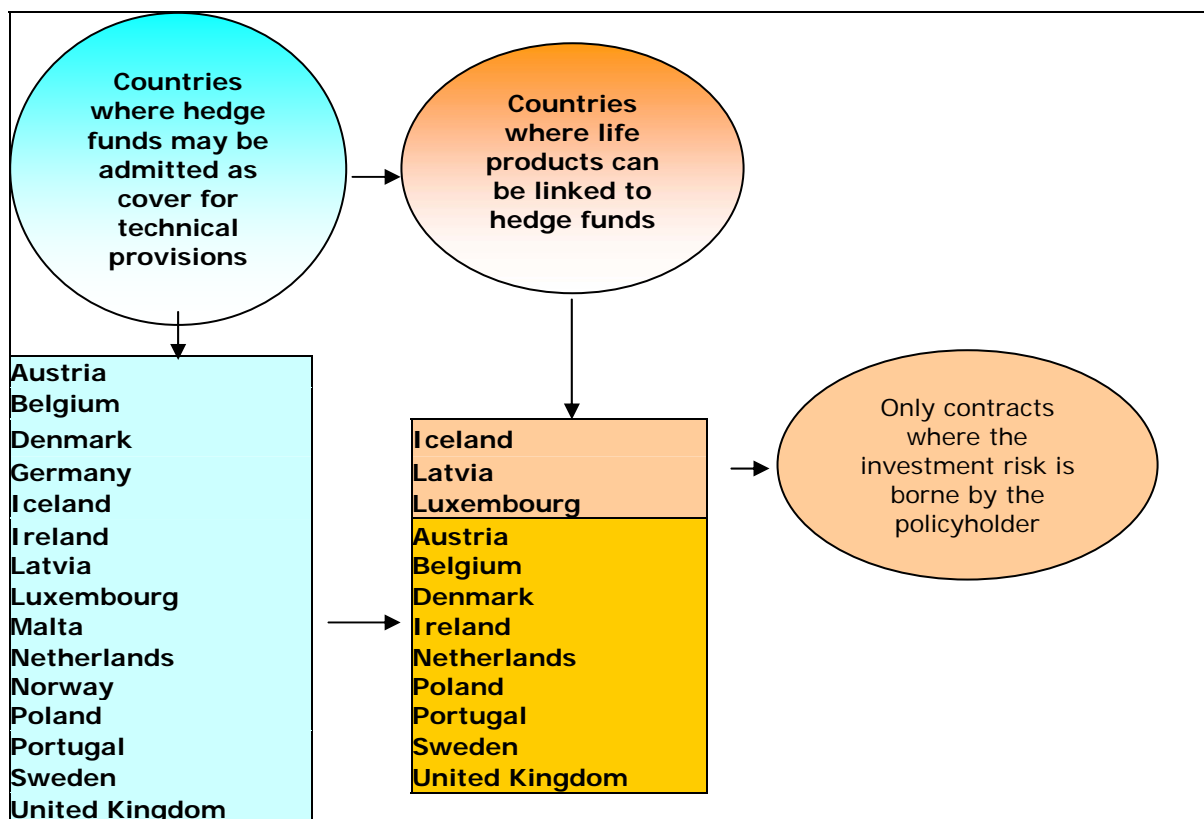
In compliance with the provisions of Community directives, which do not envisage any quantitative restriction concerning insurance companies’ *free assets*, the survey has shown that there are no particular conditions set by the single Member States in this regard. By and large undertakings must comply with the principle of prudence where adequate knowledge and experience is required in the field of alternative investments, and must have adequate control and monitoring systems for a correct assessment and management of the risks linked to this type of investment³.

³ In the UK, although investment of free assets in hedge funds is not prevented there are quantitative restrictions in that for the purpose of assessing capital adequacy, the same categories of assets are regarded as admissible and the same limits apply to admissible assets. If a hedge fund that is not required to cover technical provisions is inadmissible or subject to admissibility limits then same or all the investment may be given a zero value for capital adequacy purposes.

4. Hedge funds and life assurance products

From the survey it has come out that none of the States (EE, ES, FR, HU, IT, LT, SI and SK) which prohibit the use of hedge funds as assets representing technical provisions allow their use in life assurance products. Furthermore (see fig. 2), not all the countries that admit these funds among the categories of assets to be used as cover for technical provisions also envisage the possibility to directly (or indirectly) link the benefits or surrender value of life policies to units in hedge funds or to structured products linked to hedge funds (DE and MT). Where this possibility is envisaged (AT, BE, DK, IE, IS, LU, LV, NL, PL, PT, SE, UK), in some cases it only regards contracts where the investment risk is borne by the policyholder (AT, IS, LU and LV).

Fig. 2 - Possibility to link life policies to hedge funds



In general, the countries that admit the marketing of life policies linked to hedge funds apply more stringent rules, especially as regards disclosure.

More detailed information is provided below in relation to countries where the benefits or surrender value of life policies can be directly (or indirectly) linked to units in hedge funds or to structured products linked to such funds.

Austria allows the marketing of life policies linked to hedge funds only in relation to unit- and index-linked contracts. An investor profile helps to assess the information and consultancy needs of policyholder. The aim of consultancy is that the policyholder selects only such products about the functioning and risks of which he is sufficiently informed, which are in line with his investment goals and investment horizon, and which are acceptable within the framework of his financial circumstances. If the potential policyholder does not provide detailed information on his/her personal situation, his/her refusal must be reported and undersigned in the contract. The information requirements are more stringent in the case of products without a guaranteed capital, since the policyholder bears all the investment risk. Prior to the conclusion of a contract, the policyholder shall be provided with sufficient information on the investment (e.g. composition of the fund, performance of the fund to date in the case of unit-linked life assurance and/or performance of the reference value to date in the case of index-linked life assurance). An offer shall be prepared on the basis of the policyholder's individual circumstances (age, gender, term, premium amount and method of payment of the premiums), but using the given percentages of an assumed performance of the reference value on which the insurance is based (e.g. funds, share index) amounting to 0%, 3% and 6%. The policyholder shall be clearly advised that, if the product does not include a capital guarantee, losses in the fund assets may occur and that the amount to be paid out from his insurance contract may be lower than the total premiums paid in. The assumptions on which the representation is based shall be clearly pointed out. The policyholder must receive adequate information, also through periodic communications, during the life of the contract.

Belgium Denmark and Ireland allow the use of hedge funds without establishing specific rules. Generally speaking, these contracts are subject to the same general rules on disclosure applicable to all products. In Belgium, when they deal with product where the investment risk is borne by the policyholder, the same general rules on disclosure foreseen for the unit-linked policies are applied. For those unit-linked products detailed information is required on the fund (i.e.: its investment strategies, the methods used to determine the value of the unit and the frequency of publication, as well as on the method used to determine loadings). In Denmark limits are met only when the risk is borne by the undertaking (the total limit for investment in hedge funds is 10%; 2% per single hedge fund), while no limits apply if the policyholder bears the investment risk.

In Luxembourg the use of hedge funds is only allowed for unit-linked contracts; however it has been established that the fund must be licensed or subject to the supervision by a supervisory authority. Further restrictions apply to the type of fund, the country of the issuer, the minimum rating and frequency of unit repayability, although there are no specific requirements on the minimum number of participants to the fund or on the minimum amount of initial subscription.

In Iceland and Latvia only policies where the risk is borne by the policyholder can be linked to hedge funds; however Iceland has also pointed out that up to now no company has marketed this kind of contracts.

In the Netherlands and Poland it is allowed to sell life policies linked to hedge funds or to structured products linked to such funds without any particular restrictions. In the Netherlands in particular, it is up to each insurer to determine whether these funds may be offered to their clients via unit-linked insurance products. When such hedge funds have been allowed to be distributed to the general public, this may be seen as a positive signal by insurers. The Netherlands put greater emphasis on “market conduct”, than on the role of the supervisor which is only called upon to express its opinion. Under the Polish law, policyholders must be informed on the level of risk inherent to the product and the supervisory authority has the exclusive task of supervising that the fund does not exceed the level of risk.

In Portugal the benefits of life assurance contracts can be linked to hedge funds, and no specific rules apply to this type of products. In fact, such contracts are subject to the same general rules envisaged for life assurance contracts, which have been supplemented by more detailed provisions concerning unit-linked contracts. Pre-contractual information must draw the policyholder’s attention to risk exposure, as well as to any other element that may improve the quality of information and the understanding of the product risk profile. The undertaking must in fact inform the policyholder of the possibility of loss of the invested sums, of the existence of minimum guarantees and on the volatility of the product.

In the United Kingdom collective investment schemes backing linked policies have to comply with the provisions established by the FSA and, in particular, they must either be UCITS or meet criteria as to frequency of valuation, realisability and be restricted to investments which are themselves listed by UK regulation as “permitted by links”. Holdings in non UCITS collective investment schemes may not in aggregate exceed 10% of the linked benefits, unless the contract under which the benefits are payable has been marketed in accordance with any legal restrictions which apply to the marketing of the corresponding collective investment scheme.

In practice, many hedge funds which use short selling (also through derivatives) or have low liquidity are excluded from the category of “permitted links” and, therefore, cannot be linked to linked products.

In Sweden too funds (including hedge funds) linked to life assurance products must, under a “look through” approach, comply with the provisions regulating insurance investments. Only open funds with a predetermined frequency of unit repayability are admitted. Non-Swedish funds must be either UCITS or specially approved by the Swedish supervisory authority, although for funds linked to conditional bonus there are no such restrictions. The Swedish legislation lays down requirements for diversification and containment of the financial risk, but establishes no criteria for rating or limit to the use of financial leverage, and there are no regulations on the minimum number of participants or on the minimum amount of initial subscription. Funds linked to contracts with minimum guarantees may use derivatives only for hedging purposes or for purposes of efficient portfolio management and they must have underlying assets chosen among those allowed as cover for technical provisions under the regulation.

5. Conclusions

The survey has shown (see figure 1) that out of the 23 countries that have answered the questionnaire, 15 have not expressly disallowed the use of hedge funds as cover for technical provisions, while in 3 countries this is allowed only for investments for the benefit of life-assurance policyholders who bear the investment risk.

The countries that allow the use of these assets have various limits that apply to them. Some countries follow the “look through” approach, i.e. they admit only those hedge funds which invest and take on positions consistent with the limits set by national legislations on assets representing technical provisions; other countries have set quantitative limits to their use, with a view to a greater portfolio diversification. Others, then, have adopted a mixed solution, setting both qualitative and quantitative limits.

The 8 countries that prohibit the use of hedge funds have judged this category of assets as non compatible with the principles of safety, yield and marketability sanctioned by Community regulations. Moreover, the widespread use by hedge funds of financial leverage and of short selling (frequently by taking on short positions in derivatives) often makes these instruments not compliant with the strict insurance regulations which allow the investment in financial derivatives only for hedging and for efficient portfolio management purposes.

Of the 15 countries which admit hedge funds as cover for technical provisions, 12 also envisage the possibility to directly (or indirectly) link insurance products to these types of assets; and at least 4 of them restrict such possibility only to index- or unit-linked contracts (see table 1).

The survey has also shown that the countries that admit the marketing of insurance policies linked to hedge funds apply more stringent rules as regards disclosure.

Table 1 - Summary scheme

Country	ID	Admissibility as cover for technical provisions ⁴		Possibility to sell insurance products linked to the performance of hedge funds	Only for unit- and index-linked
		Item C	Item D		
Austria	AT	Y	Y	Y	Y
Belgium	BE	Y	Y	Y	N
Cyprus	CY	N.A.	N.A.	N.A.	N.A.
Czech Republic	CZ	N.A.	N.A.	N.A.	N.A.
Germany	DE	Y	N	N	N
Denmark	DK	Y	Y	Y	N
Estonia	EE	N	N	N	N
Spain	ES	N	N	N	N
Finland	FI	N.A.	N.A.	N.A.	N.A.
France	FR	N	N	N	N
Greece	GR	N.A.	N.A.	N.A.	N.A.
Hungary	HU	N	N	N	N
Ireland	IE	Y	Y	Y	N
Iceland	IS	N	Y	Y	Y
Italy	IT	N	N	N	N
Liechtenstein	LI	N.A.	N.A.	N.A.	N.A.
Lithuania	LT	N	N	N	N
Luxembourg	LU	N	Y	Y	Y
Latvia	LV	N	Y	Y	Y
Malta	MT	Y	N	N	N
Netherlands	NL	Y	Y	Y	N
Norway	NO	Y	Y	N.A.	N.A.
Poland	PL	Y	Y	Y	N
Portugal	PT	Y	Y	Y	N
Sweden	SE	Y	Y	Y	N
Slovenia	SI	N	N	N	N
Slovakia	SK	N	N	N	N
United Kingdom	UK	Y	Y	Y	N

⁴ See Council directive 91/674/EEC: item C. refers to Investments and item D. refers to the investments for the benefit of life-assurance policyholders who bear the investment risk.

