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## **Banking and Payments Authority of Kosovo**

Pursuant to the authority given under Section 17.b of UNMIK Regulation No. 2001/24 date of October 1, 2001 on Amending UNMIK Regulation No. 1999/20, on Banking and Payments Authority of Kosovo and Section 3.3 of UNMIK Regulation No.2001/25 date of October 5, 2001 on Licensing, Supervision and Regulation of Insurance Companies and Insurance intermediaries,

For the purpose of execution Section 42 of UNMIK Regulation Nr. 2001/25

Governing Board of the Banking and Payment Authority of Kosovo, at the meeting held on March 28, 2002 adopt the following:

### **Rule 17 on Derivative Financial Products**

#### **Section 1**

##### **1. Scope of Rule**

This rule applies to all insurance companies and insurance intermediaries licensed by the BPK.

##### **2. Legal Authority**

This rule implements Section 42, Chapter VI (Prudential Matters) of the Insurance Regulations.

##### **3. Definitions**

In this rule, the followings terms mean:

“Derivative product” or “derivative” is a financial asset or liability whose value depends on (or is derived from) other assets, liabilities or indexes (the underlying asset). Derivatives are financial contracts and include a wide assortment of instruments, such as forwards, futures, options, puts and calls, warrants, swaps and composites. In this rule, any structured product that has the effect of a derivative is deemed a derivative product.

“Board of directors” means the highest-ranking governing body of a corporation composed of members appointed by the voting equity holders. In this rule, the term “board of directors” refers to:

- a) In the case of a corporation or company created and existing under the laws of Kosovo, the board of directors body, itself.
- b) In the case of a foreign company incorporated in another jurisdiction, but which is licensed to conduct insurance business in Kosovo, the senior officer of the company's office in Kosovo, who is a resident of Kosovo and accepted as such by the BPK.

"Board" refers to board of directors as defined in this rule.

"Company" refers to either, or both, insurance company or insurance intermediary company.

"Cash-flow risk" means the risk associated with the company's ability to finance its derivative activities, such as in meeting margin calls on futures contracts.

"Composite" is a combination of two or more standard derivatives to achieve a specified objective.

"Counter-party" or "counterpart" refers to the other party with whom a company makes a derivative contract.

"Credit risk" is the risk that a counterpart will not pay under the terms of the derivative contract and may eventually default on its obligations.

"Liquidity risk" is the risk that the company may not be able to unwind or offset its position in a derivative transaction at or near market price because of inadequate market or because of a market disruption.

"Market risk" is the risk that the company is exposed resulting from adverse movements in various factors, such as stocks, bonds, interest rates, exchange rates, consumer price indexes, etc., that affect financial product markets.

"Operational risk" is the risk of an unexpected loss resulting from deficiencies in information management, system of internal controls or the competence in the management of derivatives.

## **Section 2** **Investment and Use of Derivatives**

### **1. Restriction in the Transaction of Derivatives**

No licensed company may transact in, or enter into any kind of contract involving, derivative products without the prior approval of the BPK.

## **2. Prior Approval of BPK, Required:**

Any licensed company desiring to transact in any derivative product must submit to the BPK its plan or proposal for approval. BPK, at its discretion, may approve and authorize a company to enter into a contract involving specific derivative products where it is satisfied that:

- a) The board of directors of the company submits a proposed investment plan specifying the targeted derivative contracts and products, attaching therewith the resolution of the board approving the proposed derivative transaction(s).
- b) No assets of the company pertaining to its technical provisions, the amounts representing the minimum required capital and margin of solvency are allocated or used for derivative products and contracts.
- c) The company has, in place, an adequate and effective policy formulated and approved by the board of directors for the use and transaction of derivatives. The policy is consistent with the company's business activities, its overall investment objectives, its asset/liability management strategy, and its risk tolerance. The policy addresses the following elements to the satisfaction of BPK:
  1. The purpose for which the derivatives is used and its specific investment objective.
  2. The establishment of appropriately structured exposure limits, single and aggregate, for such derivative products taking into account the purpose of their use and the uncertainty cause by market, credit, liquidity, cash-flow, operational and legal risks.
  3. Restrictions on holding certain types of derivatives such as those where risk exposure cannot be reliably measured and controlled, where unwinding of positions or liquidation or disposal of the derivative could be difficult, where independent price verification is not available and others the board or the BPK finds necessary considering the size of the company and its scale of business.
  4. Lines of responsibility and accountability on the transactions of derivatives are clearly set and established corresponding to the

qualification, integrity and technical competence of every company officer or employee that is involved in derivative transactions.

- d) The company has a risk management system in place capable of identifying, measuring, controlling and reporting to the BPK and the board the risks in the company's derivative activities.
- e) The company has, in place, adequate and effective internal control procedures to ensure that derivative activities are properly monitored and controlled and that transactions entered into are strictly consistent with the approved policies and procedures and in compliance with all legal and regulatory requirements.
- f) The company has qualified and competent internal full-time audit personnel equipped with sufficient technical and market know-how on derivatives and capable of verifying and validating prudential standards applied in derivative transactions and of reporting risk aversions to the board in a timely fashion.
- g) The board of directors is reasonably equipped with adequate knowledge and expertise in understanding important issues related to the use of derivatives and that every individual conducting, monitoring and controlling derivative transactions are suitably qualified and competent, in addition their having passed the "fit and proper" requirements prescribed by the BPK.
- h) The board of directors conducts a quarterly review (coinciding with the company's quarter period) of the company's derivatives policies and procedures to ensure its adequacy and effectiveness taking into account the company's activities, its overall risk tolerance and market conditions; and, within 15 days following the end of the each quarter period, submits to the BPK its review findings, the degree of adherence to approved policies and procedures, the corresponding financial impact on the company and the actions taken by the board in relation thereto.
- i) The company is in compliance with all the provisions of the Insurance Regulation, these Rules and all directives of the BPK consistent thereto.

### **3. Withdrawal or Revocation of BPK Approval**

BPK, at any time, may withdraw or revoke a prior approval authorizing a licensed company to use derivatives and/or enter into contracts involving derivatives, when it finds that:

- a) The company is transacting in derivatives in a manner that is not consistent with any of the criteria prescribed by the board or by directives issued by the BPK in the discharge of its supervisory oversight.
- b) If the report of the board of directors prescribed under paragraph h) of sub-section 2, above is not submitted to the BPK as required under this rule; or if the report submitted fails to provide adequate information for the BPK to reasonably assess and evaluate the derivative transactions, positions and exposures of the company.
- c) For any other reasons considered by the BPK as necessary to protect or preserve the interest of the policyholders of the company.

## **Section 3 Compliance**

### **1. Disclosure Requirements**

Any licensed company authorized by the BPK to use derivatives or to enter into contracts involving derivatives must disclose, in its audited annual statement and in all its quarterly and annual financial report submissions to the BPK, the qualitative and quantitative information and analysis of the company's derivative activities. AT the expenses of the company, these disclosures must also be published in a newspaper of general circulation in Kosovo, within 10 days from the date they are submitted to the BPK.

### **2. Effect of Non-Approval by the BPK and Non Disclosure**

If the proposed plan to use and transact derivatives is denied, BPK shall so notify the company in writing specifying its objections. Unless and until the company takes into account the objections to the satisfaction of the BPK, the proposed plan is not approved. A withdrawal or revocation of a previous approval authorizing a company to use and transact in derivatives has the force and effect of non-approval.

If a company executes or implements any derivative transaction without the approval of the BPK; or if the company fails to make the proper disclosures prescribed by this Rule:

- a) The license of the company may be suspended or revoked and

the BPK may take further steps as are necessary consistent with the provisions of the Insurance Regulation and these Rules.

- b) At the discretion of the BPK, provided that no part of the company's assets corresponding to its technical provisions and amounts representing the minimum required capital and margin of solvency are exposed to derivative products or contracts, and if warranted by the nature and extent of the derivative transaction, the licensed of the company may be subjected to certain conditions such as, but not limited to, prescribing specific period of time for the company to unwind and disposed of its derivative positions, restriction on the types of obligations and securities as permitted investment, restrictions on the company's underwriting and risk acceptance, or any other such conditions as the BKP deem appropriate under the circumstances.

#### **Section 4 Entry into Force**

This present rule shall enter into force on April 1, 2002.

David Weatherman  
Acting Managing Director