

POLICY ON THE USE OF DERIVATIVES



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NAMBAWAN SUPER POLICY ON THE USE OF DERIVATIVES

1. GOVERNANCE AND REGULATORY REQUIREMENTS

1.1 Legal and Regulatory Provisions

Nambawan Super Fund (“the Fund”) is an Authorized Superannuation Fund (“ASF”) pursuant to section 8 of the *Superannuation (General Provisions) Act 2000* (“SGP Act”) and is authorized by the Bank of Papua New Guinea (“the Bank”) to operate as a superannuation fund.

The Bank has determined the *Superannuation Prudential Standard 1/2014 Approved Superannuation Funds’ Investments* (“PS1/2014”) to prescribe requirements about an ASF’s investments and related matters. In particular, PS1/2014 includes detailed provisions relating to the use of derivatives by Approved Superannuation Funds, and this policy includes specific measures to ensure compliance.

Nambawan Super Limited as Trustee for Nambawan Super Fund (the Fund), in consultation with the Licensed Investment Manager (LIM), has developed this Policy on Use of Derivatives to capture, measure, and manage the potential risks of any derivatives positions taken, directly or indirectly. The Policy on the Use of Derivatives is published in the Annual Report to members, and in the public section of the Fund’s web site.

2. PURPOSE OF THIS POLICY

2.1 Purpose

The purpose of the Policy on the Use of Derivatives is to provide governing principles for the oversight of the use of derivatives in management of the Fund’s investment assets.

2.2 Background

The regulatory provisions governing the use of derivatives are contained in par 34 of PS1/2014. The provisions impose an obligation on the Trustee Board and LIM to ensure that the assets and liabilities of an ASF do not include a derivative, either directly or indirectly, unless permitted by Par 34(b) to (e).

The effect of the regulatory provisions is to permit the use of derivatives by an ASF only by exception, that is, if certain conditions are met. Those conditions are:

- i. Each member of the Trustee Board fully understands and is able to explain the potential risks of any derivatives positions taken, directly or indirectly [par 34(b)];
- ii. Derivatives will only be used to reduce the risk of existing investments or currency positions [par34(c)];
- iii. The effective exposure of the derivatives is fully covered by assets of the Fund [par34(d)]; and

- iv. The Trustee Board develops, documents, and maintains a Policy on the Use of Derivatives, in consultation with the LIM, and includes the policy as part of the Investment Framework [par34(e)].

3. DERIVATIVES

3.1 Definition

A derivative is a financial instrument whose value depends on, or is derived from, the value of some other underlying asset (real or financial), or index.

3.2 Types of Derivatives

Derivatives may be categorised by reference to the underlying assets from which their value is derived. These categories include: Equities; Currencies; Interest Rates; Credit; and Commodities.

Common types of derivatives include forward contracts, futures contracts, options and swaps. Each derivative has its own risks, regulatory, and contractual requirements.

Derivatives can be traded through exchanges or privately 'over the counter' (OTC).

3.3 Uses of Derivatives

- a. Derivatives are commonly used to improve the risk/return profile of an investment portfolio and to improve the chances of the portfolio in meeting its objectives;
- b. Derivatives can facilitate the management of investment risks and/or provide an efficient means of implementing various market exposures and investment strategies;
- c. Common uses of derivatives include the following:
 - i. To hedge or control investment risks; such as using forward foreign exchange contracts to hedge currency risks;
 - ii. To gain access to investment exposures that are otherwise unavailable; (for example, to international equities when it is not possible to buy the underlying equities due to shortages of foreign currency, or because the market is not open to PNG investors);
 - iii. To gain access to investment exposures quickly; to a market, before the cash is gathered to invest in the underlying investments. Once the cash is gathered, the derivative can be reversed as the underlying investments are purchased;
 - iv. To gain access to international investment exposures without being exposed to currency risks; which arise when PNG Kina is converted to foreign currency and used to invest in the underlying investments;
 - v. To implement investment strategies in a low cost and efficient manner;
 - vi. To create economic exposure to a wider set of investment opportunities than might be available in the Fund's home market, or within the Fund's regular investment universe;
 - vii. To create 'leveraged' positions, that is, to gain access to investment exposure that exceeds cash holdings. Leverage increases investment risk, and PS1/2014 explicitly provides that derivatives may only be



used when the investment exposure is fully covered by the assets of the Fund;

- viii. Trading, speculation, arbitrage, and “alpha-generation”:

4. RISK MANAGEMENT

The Trustee Board and the LIM understand that derivatives are instruments that may make it easier to manage investment risk.

The Trustee Board, in consultation with the LIM, will develop, document and maintain an appropriate risk management system to capture, measure, monitor and manage the potential risks of any derivatives positions taken directly or indirectly. These measures are documented in Section 5.

The derivatives risk management system forms part of the Fund’s overall Risk Management Framework, is specific to the risk management of derivatives, and is sophisticated enough to measure risks on an aggregate basis.

5. IMPLEMENTATION

The Trustee Board and the LIM expect that the use of derivatives by the Fund will be limited to the Fund’s international investments.

The Fund’s international exposure is now implemented through investment in externally managed funds and exchange traded funds (ETFs). As a result, the Trustee Board and the LIM expect that the use of derivatives by the Fund will be implemented indirectly, by its externally appointed managers.

In order to ensure compliance with the requirements of PS1/2014, the Trustee Board, in consultation with the LIM, has directed that the following measures be undertaken:

- i. The Investment Committee considers all new investment proposals, and maintains a list of Approved Fund Managers and Approved Mutual Funds that meet the Fund’s requirements. Inclusion on the Approved List does not constitute an investment proposal and does not imply the Fund intends to invest with an Approved Manager, or in an Approved Fund. The Approved Lists allow for consideration and review of potential investments over time.
- ii. In considering a proposal for admission to the list of Approved Funds, the Investment Committee requires that the Fund, in consultation with the LIM, provide a detailed analysis of the mutual fund’s constituent documents, including the fund Prospectus, Information Memorandum, and Fact Sheet, to determine the authorised use of derivatives by the Approved Fund’s managers. The analysis must include:
 - a. The types of derivatives authorised for use;
 - b. The purpose/s for which derivatives are authorised for use;
 - c. The limits on the underlying market exposure the fund may obtain through the use of derivatives;
 - d. The risks associated with derivatives authorised for use;
 - e. The risk management system for the capture, measurement, monitoring, and management of derivatives authorised for use;
- iii. A recommendation for admission to the list of Approved Funds must include an assessment that the types of derivatives authorised for use, and the purpose

for which their use is authorised, are consistent with the requirements of PS1/2014. In making this assessment:

- a. Standard or “vanilla” derivatives, such as forward contracts, futures, options and swaps, are types of derivatives that may be considered consistent with the requirements of PS1/2014. Complex derivatives, including complex over-the-counter derivatives, may be considered inconsistent with the requirements of PS1/2014;
- b. Hedging, risk management, and efficient execution, are purposes for the use of derivatives that may be considered consistent with the requirements of PS1/2014. Speculation, trading, or ‘alpha-generation’, are purposes for the use of derivatives which may be considered inconsistent with the requirements of PS1/2014;
- iv. Where the constituent documents of the mutual fund authorise use of a derivative not consistent with the requirements of PS1/2014, or use of a derivative for a purpose not consistent with the requirements of PS1/2014, the proposal for admission to the Approved List may only be considered if the Approved Manager confirms, in writing, that such derivatives are not used, or not used for that purpose;
- v. In endorsing and investment proposal for investment in a fund on the Approved Funds List, the Investment Committee must confirm that the above requirements have been complied with, and the use of derivatives is consistent with the requirements of PS1/2014;
- vi. In approving a proposal for investment in a fund on the Approved Funds List, the Trustee Board must confirm that the above requirements have been complied with, and the use of derivatives is consistent with the requirements of PS1/2014;
- vii. The Fund, in consultation with the LIM, will conduct training sessions for members of the Trustee Board when required to ensure that each member of the Trustee Board fully understands and is able to explain the potential risks of any derivatives positions taken. Additionally, the Fund, in consultation with the LIM, may provide training to the Trustee Board when new types of derivatives instruments permitted under PS1/2014 are used by the mutual funds in which the Fund has an investment exposure.
- viii. Management will regularly report to the Trustee Board on the types of derivatives instruments used in the mutual funds in which the Fund has an investment exposure.

6. REVIEW

The Trustee Board regularly reviews the Policy on the Use of Derivatives in consultation with the LIM, and at least annually.

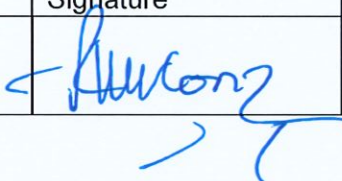
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