

07/7\*\*

Financial Services Authority

# Permitted Links for Long Term Insurance Business

March 2007





# Contents

1	Overview	3
2	Introduction	8
3	Principles on which high level rules are based	11
4	List of assets which may be linked	16

**Annex 1:** Compatibility Statement

**Annex 2:** Cost Benefit Analysis

**Annex 3:** List of Questions

**Appendix 1:** Draft Handbook Text and Glossary

The Financial Services Authority invites comments on this Consultation Paper. Comments should reach us by 28 June 2007.

Comments may be sent by electronic submission using the form on the FSA's website at ([www.fsa.gov.uk/Pages/Library/Policy/CP/2007/cp07\\_07\\_response.html](http://www.fsa.gov.uk/Pages/Library/Policy/CP/2007/cp07_07_response.html)).

Alternatively, please send comments in writing to:

Peter Morris  
Retail Policy Division  
Financial Services Authority  
25 The North Colonnade  
Canary Wharf  
London E14 5HS

Telephone: 020 7066 9572  
Fax: 020 7066 1099  
E-mail: [cp07\\_07@fsa.gov.uk](mailto:cp07_07@fsa.gov.uk)

**It is the FSA's policy to make all responses to formal consultation available for public inspection unless the respondent requests otherwise. A standard confidentiality statement in an e-mail message will not be regarded as a request for non-disclosure.**

**A confidential response may be requested from us under the Freedom of Information Act 2000. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the Information Commissioner and the Information Tribunal.**

Copies of this Consultation Paper are available to download from our website – [www.fsa.gov.uk](http://www.fsa.gov.uk). Alternatively, paper copies can be obtained by calling the FSA order line: 0845 608 2372.

# 1 Overview

## Context

- 1.1 The purpose of this Consultation Paper (CP) is to present for consultation proposed changes to the permitted links rules. It fulfils the commitment we made in our 2006/07 Business Plan to conduct a review of the permitted links rules.

## Business Plan

- 1.2 The Business Plan stated: ‘There are ... inconsistencies between the existing rules on permitted links for unit-linked insurance and the rules for collective investment schemes. The existing policy has not been revised since the early 1990s, and does not reflect subsequent changes in the market or in parallel regulatory arrangements for collective investment schemes (CIS). As a result we have received a large number of waiver applications over recent months. We will conduct a review of the permitted links regime.’

## Background

- 1.3 The rules governing eligible investments for linked long term life assurance, the permitted links rules, have been in place in their current form since 1994. They have not been substantially reviewed since then.<sup>1</sup>
- 1.4 We intend to make changes because we believe that our rules have created regulatory failure in that they:
- have not kept up to date with market conditions;
  - are creating market distortion, and;
  - give the opportunity for regulatory arbitrage.

---

<sup>1</sup> While carrying out this review we identified a change to the rules which we could implement before we completed the full review. We published in the October 2006 Quarterly Consultation Paper (CP06/18) proposals that a ‘non retail UCITS scheme’ (‘NURS’) should automatically be a permitted link in the same way as a UCITS. We received strong support for our proposal which subsequently came into effect on 31 December 2006. For further information please refer to Chapter 3 of CP06/18 and Handbook Notice 61 paras 2.6 – 2.10.

## *Market Conditions*

- 1.5 The current rules include some detailed requirements that create unjustified difficulties. For example, unit-linked insurance funds may invest directly in property but cannot, without a waiver, invest in property through a collective vehicle that might offer greater diversification with no materially greater risk. The rules also require all assets to comply with the relevant requirements with no exception, however small. So a waiver is required whenever any situation arises that means an asset no longer complies with the rules.

## *Current rules creating market distortion*

- 1.6 There are material cost incentives for pension funds to invest through insurance company pooled funds instead of holding the underlying assets directly. Our current rules are based on the need to protect retail policyholders. This can make them unduly restrictive for institutional policyholders who have access to professional advice and a wider range of investments on a direct basis. Pension funds are therefore restricted in their ability to diversify their portfolios in this cost effective way and will often invest offshore to get round this problem. We are, however, limited by EC directive constraints<sup>2</sup> in the extent to which we can make changes.

## *Regulatory Arbitrage*

- 1.7 The New Collective Investment Schemes (COLL) rules for authorised collective investment scheme (CIS) products and the permitted links rules for life office products have been developed over the years from very different directions. They consequently differ in a number of significant ways that potentially create the opportunity for regulatory arbitrage. We do not think it would be practical simply to import the COLL rules as they stand to apply to permitted links, but the review does provide the opportunity to remove major inconsistencies in outcome between the two regimes. We refer to this in more detail in paragraphs 4.16-4.26.

## **More Principles-Based Regulation**

- 1.8 Our proposals aim to take away outdated and unnecessary detail, and replace it with more principles-based high-level rules. This is a practical expression of our stated aim of moving towards more principles-based regulation (MPBR).
- 1.9 The outcome of this more principles-based regulation should be to give firms greater flexibility in designing products while maintaining the appropriate level of consumer protection.
- 1.10 There have been no market failures in this area in the past<sup>3</sup>. This has partly been because of the strict definitions of what these funds can invest in. We want to ensure that relaxing these rules and allowing greater flexibility does not put at greater risk,

---

2 The review of the Permitted Links rules is restricted by the requirements of the Consolidated Life Directive 2002/83/EC (CLD). Articles 23 and 25 set out the relevant constraints.

3 Unit-linked life and pension policies have been mis-sold but firms have breached the Conduct of Business (COB) rules in doing so. This review focuses on the rules governing the assets that may be used by firms carrying on unit-linked business.

whether disclosed or not, those policyholders who are unable to understand that risk or for whom it may be unacceptable. It will be up to firms themselves to decide whether they wish to take advantage of the greater freedom we intend to offer.

- 1.11 At the same time we are giving investors who have greater understanding of risk some opportunity to take advantage of wider investment choices, according to their appetite for risk.
- 1.12 In July 2006 we published our paper ‘Treating Customers Fairly – towards fair outcomes for consumers’. In this we set out to explain the outcomes for consumers that we are looking to achieve through our Treating Customers Fairly (TCF) initiative. This initiative aims to deliver six improved outcomes for retail consumers, and firms should be focused on trying to achieve these outcomes. We believe our proposed use of principles-based high-level rules allows us to embed our requirement under our TCF initiative within them.

### **Scope of the Review**

- 1.13 The current permitted links rules give a list of assets that unit-linked policies are permitted to base benefits on. Anything not on the list is not allowed. Currently any firm wishing to use excluded assets has to apply for a waiver of or modification to the rules.
- 1.14 What is in the scope of the review is:
- the categories of assets, by reference to which the benefits payable under unit-linked and index-linked policies may be determined;<sup>4</sup> and
  - limitations on the nature or quantity of these assets which have to be imposed because we believe that going beyond the minimum EC directive requirements is justified by the need for appropriate consumer protection.
- 1.15 Beyond a few specific issues, the general matter of governance of unit funds is not being considered by this review in detail. This is because our Business Plan 2006/7 stated that on ‘unit-linked insurance, our aim will be to promote a level playing field for packaged products by improving operational standards relating to pricing, and ensuring appropriate product governance. As a first initiative in this area, we are working with industry bodies to produce a good practice guide which will help clarify expectations in relation to the pricing of unit-linked funds.’
- 1.16 To this effect, the Association of British Insurers (ABI) published a guide – *A Guide of Good Practice for Unit-Linked Funds* – on 1 June 2006. We are working with the ABI on a review of the practices their member firms used against the standards set out in the guide.

---

<sup>4</sup> The assets used to determine the benefits to be paid under linked long term policies do not necessarily have to be held in a unit-linked fund. They could be a single asset such as a UCITS or a specified index. However, using unit-linked funds is the norm and for the sake of simplicity we refer to unit-linked funds throughout this CP.

1.17 A thematic project carried out in 2004 identified several weaknesses in firms' operating practices for unit-linked funds including for unit pricing and pricing errors. The findings concluded that:

- there was less standardisation of systems and controls and pricing methodologies adopted for unit-linked funds than for CIS;
- there was no clear disclosure for pricing methodologies, creating a risk that either the policies or their inconsistent application could lead to customer detriment;
- though firms generally sought to adopt unit trust standards for pricing controls, in some areas not all of the controls were present and some controls adopted did not seem to warrant the comfort taken from them; and
- there is no standardised procedure for firms to deal with pricing errors.

### **Method of review**

- 1.18 In carrying out this review we wanted to challenge our thinking about the purpose of the permitted links rules. Although we understand that markets change very rapidly, the overarching objectives of the rules should be clear. We also acknowledge the importance of linked funds' position in the UK financial services market, and want to ensure that our rules do not reduce the UK's competitiveness in this market.
- 1.19 We believe the rules' aims and objectives are to provide transparency and protection to the policyholder while allowing innovation and investment. It should always be clear to the policyholder what underlying investments their policy benefits will be paid on.
- 1.20 We want to ensure that using layered or opaque investment techniques does not obscure what we consider the essential and continuing transparency of linked funds. However, we do wish to encourage innovation and investment in the UK markets as long as it is not to the detriment of consumer protection.
- 1.21 As we accept that the current rules are out of date, we have taken the opportunity to return to some basic questions, for example, what should regulation really be concerned with? We have developed our proposals within the limitations applied by the Consolidated Life Directive (CLD).
- 1.22 We have found that the rules as they currently stand are not always easy to interpret. We also considered the benefits added by the guidance that we deleted from the IPRU (INS) Sourcebook in 2004. This has often been useful when providing individual guidance or considering applications for modifications to our rules. Practitioners have also continued to find this guidance useful.
- 1.23 As a regulator who is interested in 'Better Regulation' we wanted to examine all measures being proposed that go further than the CLD minimum requirements, to ensure we follow our 'Principles of Good Regulation'. We believe where we have gone further than the minimum requirements of the CLD in these revised rules that it is fully justified.



- 1.24 In the course of preparing this Consultation Paper we have drawn on the views of a wide range of stakeholders. We wish to thank the Royal Institution of Chartered Surveyors for its assistance.

### **Who should read this paper**

- 1.25 This CP will be directly relevant to all life insurance firms and friendly societies writing unit-linked business or with existing books of unit-linked business. In addition, it will also be of interest to asset management firms and investment houses providing products and services that are used in connection with unit-linked business. Also, pension scheme trustees using unit-linked funds as a home for their members' money will also have an interest in this CP, as will their professional advisors.

### **CONSUMERS**

These proposals are relevant to consumers and consumer groups as they will affect the way in which benefits payable from both new and existing unit-linked policies are achieved.

### **Next steps**

- 1.26 This consultation will close on 28 June 2007. We will then finalise the draft rules in the light of responses to this CP and publish a policy statement giving feedback in the early autumn.

# 2 Introduction

## Background

- 2.1 It has become increasingly apparent that the permitted links rules are outdated in a number of important areas. There have been significant developments in the classes of assets available to investment funds. This is particularly widespread with property holding structures and unlisted securities. There is now a difference between the types and amounts of assets unit-linked funds and authorised or recognised CIS may hold.
- 2.2 This is mainly because the rules are intended to regulate a dynamic market which has undergone some major changes since 1994. It is demonstrated by the high volume of requests for waivers or modifications to the rules, most of which have been granted. Reviewing and granting or declining these requests requires significant resource. Such has been the demand that we have set up a streamlined procedure to deal with certain types of these applications. This in itself indicates the rules are no longer functioning as intended.
- 2.3 The UK's unit-linked market is extremely large. At the end of 2005, the assets representing these products amounted to some £650 billion and premiums paid into these products in 2005 were an estimated £110 billion. Institutional pension fund money makes up approximately 40% of the total funds under management. The rest of the investments are held on behalf of, primarily, retail investors through products such as personal and executive pensions, mortgage and savings endowments, whole of life products and investment bonds. The current rules do not recognise the different appetites for risk between wholesale and retail investors.
- 2.4 Authorised CIS are regulated by the COLL sourcebook. Differences from the permitted links rules mean there are inconsistencies between investment products which often invest in similar assets and may have broadly the same types of investor. This is because of the historical development of unit-linked assurance and CIS, their different ownership and governance structures, and the different EC directives which relate to these markets.
- 2.5 The potential outcomes of this review of the permitted links are restricted by the Consolidated Life Directive 2002/83/EC. The current list of assets available as

permitted links ('eligible assets') is based on Article 23 of the CLD. This sets out the categories of assets life insurers are allowed to use to cover their technical provisions ('admissible assets') and the principles that apply to them.

- 2.6 The current permitted links rules can also be inflexible. For example, firms holding a particular share in their unit-linked funds suddenly find they are in breach of the rules if its listing is suspended indefinitely and have to apply en masse for waivers to remedy the uncertain situation.

## **Purpose**

- 2.7 The purpose of the permitted links project is to review the current rules, to rectify acknowledged weaknesses and to reflect developments that have come about since they were put in place. Where appropriate, we propose to align them more closely with the risk profile of their investors. In doing so we intend to:
- make clear in our rules what TCF should mean for the operation of a unit-linked fund;
  - approach the review of the rules from a principles-based perspective with a clear overarching statement of the key purposes that the rules should serve;
  - take account of the differing needs of retail and institutional policyholders with interests in unit-linked funds;
  - review the suitability of the current restrictions on the range of assets and the continuing need to exclude others;
  - take into consideration, where appropriate, the regulations (primarily in COLL) that apply to other forms of collective investments. This needs to recognise the possible inconsistencies that high-level principles for permitted links could create for what could be more detailed rules in COLL;
  - eliminate, as far as practicable, the scope for regulatory arbitrage between different types of products which are regulated by different parts of our rules;
  - ensure that any changes are not only compatible with our risk-based approach to regulation but are also proportionate; and
  - reduce the need for firms to apply to us for modifications or waivers of the permitted links rules.
- 2.8 Finally, we are aware that the current rules are more complex than they need to be. Those who have to deal with them on a day-to-day basis find them overly burdensome.

## **Summary of proposals**

- 2.9 We propose to make a number of changes to the permitted links rules. We will be proposing some deregulatory changes while maintaining consumer protection. We propose to regulate the market through a set of principles given form by high-level rules. There will then be a list of assets to which these rules should be applied.

## **Deregulatory changes**

- 2.10 The main detailed deregulatory changes we are proposing to make to the current rules are:
- i) allowing investment in property through investment vehicles rather than only directly;
  - ii) allowing investment in property in properly functioning markets rather than only specified territories;
  - iii) replacing the current detailed ‘readily realisable’ requirement for certain asset types by a high-level rule, based on what is necessary for the firm to meet its policy obligations;
  - iv) allowing unlimited use of authorised or recognised CIS to institutional policyholders which we define as trustees of defined benefit occupational pension schemes; and
  - v) allowing some tolerances to avoid the need for waivers in the case of minor breaches.

## **Extra requirements**

- 2.11 The proposed permitted links rules are stricter than the minimum requirements of the CLD in the following ways:
- i) unlisted securities will be restricted by the application of the high-level rules;
  - ii) Qualified Investor Schemes (QIS)<sup>5</sup> and their equivalents in other EEA member states will be allowed without limit for institutional investors only;
  - iii) a limit is placed on unregulated CIS; and
  - iv) property is limited to that which can be purchased in any properly functioning property market (instead of being unrestricted).

## **Principles on which high-level rules are based**

- 2.12 The purpose of having high-level principles is two fold. First to apply MPBR to firms’ unit-linked fund management and second to explain and implement what Principle 6 ‘Treating Customers Fairly’ means in relation to unit-linked funds. Chapter 3 details and explains the principles and the high level rules which flow from them.

---

<sup>5</sup> Qualified Investor Schemes are authorised CIS available to professional investors on the basis of their wide investment powers as described in COLL 8.4.

# 3 Principles on which high level rules are based

- 3.1 Except where we specifically state otherwise, these principles apply to all assets that are used as reference values in unit-linked policies for the purpose of paying benefits. The principles reflect the underlying basis of linked business that the benefits paid have a direct link, either wholly or partly, to the assets underlying the policy.

## **Principle 1**

*The assets used to determine the benefits payable or the purchase price of units under linked policies must be capable of being accurately and fairly valued on an ongoing basis, realised in a timescale that enables the firm to fulfil its obligations whenever required under the policies and for an amount that can be reconciled with the previous valuation.*

- 3.2 The current requirement for some types of permitted links to be ‘readily realisable’ aims to ensure that policyholders are always able to terminate their policy for a value that is related to the current one quoted to them. However, in some circumstances this requirement may be too rigid. Assets cannot always reasonably be expected to be able to be sold within seven working days at a price within 97.5% of its stated value. In extreme cases forcing insurers to adhere to the strict letter of this rule might cause detriment to policyholders. This is already recognised in the case of land and interests in land.
- 3.3 Insurers operating long-term linked funds are able to predict with a degree of confidence when their policy obligations will fall due. This raises the question of whether it is reasonable to insist that the entire value of a fund must always be ‘readily realisable’ if this prevents it from making an illiquid investment that would be to the advantage of policyholders. We believe there is a case to be made for allowing an appropriate proportion of a long-term fund’s assets greater tolerance.
- 3.4 The current ‘readily realisable’ rules also have arguably unintended consequences when assets or markets are closed or suspended indefinitely. Any holding in such assets or markets will render a fund in breach of the rules and so require a waiver. A high profile example of this was the suspension of Railtrack shares. We believe there should be more ‘give’ in such circumstances to allow firms to remedy the situation

without needing to apply for a waiver. This would not remove the requirement to inform us about such events. Please see Principle 4.

- 3.5 We propose to allow firms to align the realisability of the assets they hold more closely with the nature of their unit-linked liabilities as outlined in this principle.

- Q1: Do you agree with our proposal to allow realisability to be based on the firm's obligations under its policies?
- Q2: What increase in risk to policyholders may arise from moving away from the current 'readily realisable' definition?

## Principle 2

*Unit-linked assets and liabilities must be closely matched at all times.*

- 3.6 This is a prudential requirement as set out fully in INSPRU 3.1.57R and 3.1.58R. INSPRU 3.1.58AR exempts pure reinsurers from this requirement. In recognition of this we propose to make further requirements, set out below, to mitigate any further risks that might arise from the use of pure reinsurance.
- 3.7 In certain circumstances the insurer is allowed to hold assets other than those which determine the unit liability. It can only do this if they are assets of appropriate safety and marketability which correspond, as closely as possible, to the assets to which the liabilities are linked. We would expect to see these cases only in the case of index-linked contracts.

## Principle 3

*The assets used to determine the benefits to be paid under a policy must not be subject to any foreseeable risk that their collective aggregate value may become negative.*

- 3.8 As the minimum policy payout value is zero, a firm would be unable to recover the deficit where the asset value became negative. This might arise, for example, if a policy was linked to a fund which borrows substantial amounts to invest and the value of the investments fell below the fund's liability to repay the borrowed amount.
- Q3: Do you agree with this principle? What effect would you expect it to have on unit-linked business in practice?

## Principle 4

*The suspension or dissolution of an individual asset, market or index to which a policy is linked, or the inclusion of small amounts of non-compliant assets will not automatically result in the entire fund ceasing to be a permitted link.*

- 3.9 We would require firms to tell us if a link became non-compliant and to take appropriate action to rectify the situation but we would not necessarily require firms

to apply for waivers or modifications to these rules after notification unless we deemed it necessary.

## **Principle 5**

*Portfolios of assets must be consistent with the risk profile and stated investment objectives presented to the policyholder.*

- 3.10 Existing unit-linked policyholders have the right to expect their interests to be protected fully in the wake of any changes to the permitted links rules. Existing funds should not use any freedom to invest in a wider range of assets in such a way that increases the risk inherent in their stated investment objectives.
- 3.11 Although diversification in itself is not a requirement of the CLD, we expect that where funds have diversification objectives, those objectives should be followed.
- 3.12 Firms can only change the nature of the benefits under a linked policy where the terms of the policy permit. If the terms of the policy do not contain specific provisions for the firm to make such a change, the firm can only do so if it gains approval from policyholders.
- 3.13 The use of reinsurance brings with it a credit risk relating to the ability of the reinsurance firm to meet its obligations. Where the terms of the policy allow this additional risk to fall on the policyholder, we would expect it, and its implications, to be properly disclosed.
- 3.14 In both of the cases identified in 3.12 and 3.13 we would consider this a failure of TCF if firms do not gain approval from and properly disclose information to policyholders.

## **Principle 6**

*Firms must be able to demonstrate to us that they have in place systems and controls that are appropriate for the risks associated with the type of assets in which they are investing.*

- 3.15 We would consider it to be a failure of TCF if a firm were to market a policy linked to assets involving risks that the firm itself was unable properly to understand and explain. It would also fail if it had insufficient skills and experience in managing or had inappropriate systems and controls in place to mitigate policyholder detriment.
- 3.16 Therefore we believe that a firm which manages unit-linked investments should be able to demonstrate visibly the systems and controls it has in place to manage the risks. We believe that this is what is expected from firms under PRIN 2.1.1R (*Principle 3 – Management and Control*).

## Principle 7

*The assets selected should not be capable of giving rise to any reasonably foreseeable conflict of interest between the life insurers managing linked funds and their policyholders. If a conflict does arise the firm should take reasonable steps to ensure that the interests of the policyholders are appropriately safeguarded.*

- 3.17 Under PRIN 2.1.1 8 – Conflicts of Interest, a firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client. In addition, for linked long-term business we believe that where a material conflict of interest needs to be settled, the settlement must not be to the detriment of the policyholder.
- 3.18 For example, we would have concerns over a choice of assets that involved a potential conflict of interest between policyholders and the firm. Such a conflict of interest might arise in the case of commercial property if the firm or a connected person were a tenant. The firm should avoid entering into such an investment, but if it has already done so it should ensure that there is an independent assessment of the rent. Another possible example might be if stock lending were to be carried out without proper consideration of the position of the policyholders.

## Principle 8

*For the purposes of these rules a firm must consider the underlying economic effect of an investment ahead of its legal form.*

- 3.19 We propose that a firm must consider the economic effect of an asset ahead of its legal form to test whether it meets the permitted links rules. This corresponds to the requirement for admissibility of derivatives for solvency purposes in GENPRU Annex 7R(3).
- 3.20 We have concerns over the prospect of an asset being arranged in such a way as to take a particular legal form. This could allow it to be treated as a permitted link when its economic effect is markedly different from what would normally be expected from an asset of that legal form, and more closely aligned with that of a type of asset that would not be a permitted link. Such an outcome would not appear to us to be consistent with a risk-based approach to regulation. An example of such a situation might be a type of deposit whose return has the nature of a speculative derivative that is not a permitted derivative or of an index that is not a permitted index.
- 3.21 However, this principle is likely to have a two-way effect. As well as filtering out some assets that we consider inappropriate, it will allow us to include some other assets that are acceptable in terms of their economic effect but whose legal form can create problems. For example, there are many different forms in which ownership of commercial property can exist. In other EEA States, it is common for such property to be held through intermediate structures such as Special Purpose Vehicles (SPV), sometimes with a complex structure, that can create difficulties with the categories of assets allowed by the permitted links rules. In our view, the two key tests that need to be satisfied are:



- (i) is the economic effect of the underlying asset class the same as that of a direct holding in a permitted link?; and
- (ii) if so, does the intermediate structure and its operation introduce any material risks to the policyholders beyond those involved in a direct holding of that asset class?

3.22 We do not intend the principle of economic effect to apply to authorised CIS.

Q4: Do you agree that, with a risk-based approach to regulation, the economic effect of an asset should be the main consideration? What consequences do you foresee as a result of this requirement?

Q5: Do you agree that all the principles achieve their purposes to afford greater flexibility to firms without added risk to consumers?

# 4 List of assets which may be linked

## **Approved securities, listed securities, unlisted securities**

- 4.1 The current rules permit ‘approved securities’, as defined in our Handbook Glossary. They are (1) securities issued by or guaranteed by governments or authorities which belong to a Zone A country or (2) loans to or deposits with approved financial institutions e.g. central banks of EEA states, the European Bank for Reconstruction and Development, other multi-regional institutions.
- 4.2 Other ‘listed securities’ are permitted if they are ‘readily realisable’. They must be listed on the Official List of the UK Listing Authority, or on a regulated market.
- 4.3 Unlisted securities are permitted if ‘readily realisable’, but are subject to a limit of 10% of the aggregate property linked benefits under the contract.
- 4.4 Apart from replacing the ‘readily realisable’ requirement with Principle 1, we do not propose to change the definition of approved securities or of listed securities that are permitted.
- 4.5 We propose to remove the restriction that limits investment in unlisted securities to 10% of property-linked benefits. This does not give an unlimited investment opportunity to all funds for unlisted securities as under Principle 5 a firm must be able to demonstrate that its permitted links are consistent with the contractual obligations to its policyholders.
- 4.6 Regardless of the principle on realisability, any unlisted security must be able to be realised in the short term.

Q6: What are the likely consequences of removing the 10% limit on unlisted securities?

## **Land**

- 4.7 Land is major asset class within the permitted links rules; it behaves in a way that sits uncomfortably with them in a number of important areas, not least relative illiquidity and intervals between revaluations.

- 4.8 We intend to discontinue the current approach of listing territories where investment in land is acceptable. Instead we propose to enable investment in land to be made anywhere where it can be demonstrated that there is a properly functioning market for transactions in land. We would want to be satisfied that the mechanics of the market are in place, for example, that surveyors are independent and appropriately qualified. So for the market to be properly functioning we would expect to see that there are:
- no artificial barriers, for example protectionist measures subordinating a UK purchaser's rights to those of nationals of a territory, to transactions; and
  - no barriers for repatriation of money to the UK.
- 4.9 The following factors might indicate a properly functioning market:
- accurate market and financial information;
  - reliable performance benchmarks;
  - enforceable contracts and property rights;
  - clarity regarding the taxation and regulation of real estate;
  - fair treatment in the transaction process including the quality of valuations; and
  - ethical standards among professionals hired to transact business.
- 4.10 We also propose to permit unauthorised CIS which invest in land or property (such as single asset vehicles, or simple collective vehicles which hold one or more assets) provided they comply with our principles. These property funds would behave in a very similar way to a direct property holding, but allow many investors to participate in the arrangement. However, to be permitted there should be no additional material risks from holding the units in the CIS over and above a direct property holding. This is intended to eliminate the irregularity that currently exists within the rules that allows a linked fund to invest directly in land but not via a CIS.
- 4.11 We propose to introduce a formal requirement which will give effect to the unwritten approach that we currently apply in practice to gearing within property funds. We therefore propose that the level of such gearing must not exceed 10%. This is consistent with the COLL rules' requirements for NURS.
- 4.12 Real Estate Investment Trusts (REITs) were introduced in January 2007 by the government as a way for investors to gain exposure to the property (land) market. REITs are listed investment trusts. REITs will be treated as listed investment trusts for the purposes of these rules and therefore permitted subject to the principles being satisfied.
- Q7: Do you agree with our proposals for the treatment of investment in land and CIS investing in land?
- Q8: Do you have any comments on the suitability of the factors we have identified as indicating a properly functioning market?

Q9: Do you believe there are any further risks or unintended consequences arising from our rules for a properly functioning market that have not been identified?

## **Loans**

- 4.13 There are two types of loan currently acceptable as permitted links. The first is a loan which is fully secured by a mortgage or a charge on land as defined in the permitted links rules. The loan cannot be wholly or mainly used for domestic purposes. The mortgage or charge must have interest rates and due dates for interest payments and repayment of capital. We believe this rule on loans continues to protect policyholders' interests and we propose to keep it as it is, subject to replacing the geographical restriction on land with a requirement for there to be a properly functioning market.
- 4.14 The rules apply to all linked contracts including those such as permanent health contracts and term assurance policies that are not in the nature of investments. If the borrower uses other resources to repay part of a single domestic mortgage, a contract of the latter type linked to the amount outstanding on the mortgage would be subject to the risk of having the benefit potentially payable reduced. This would be without reference to the amount of premium being paid, and is a situation that we would consider unfair.
- 4.15 The second type of loan currently eligible as a permitted link is a loan with an approved credit institution, approved financial institution or approved investment firm. The purpose of this requirement is to ensure that the borrower is robust enough to meet its commitments and, in the event of failure, to protect compensation to investors. We therefore propose to retain this requirement.

## **Collective Investment Funds/Collective Investment Schemes**

- 4.16 Our proposals for the treatment of CIS in the permitted links rules take account of the following factors:
- whether we have authorised the scheme (or if it is authorised by equivalent responsible authorities in another EEA member state); and
  - whether the scheme is subject to any legal restrictions as to the categories of investor it can be marketed to in the UK.
- 4.17 We propose that where a CIS is authorised in the UK so it can be freely marketed to retail customers it should automatically qualify as a permitted link. Similarly, a UCITS authorised in another EEA member State may exercise passporting rights into the UK under section 264 of FSMA to market to the general public, and such funds will qualify as a permitted link. We also propose to allow non-EEA schemes which are recognised under sections 270 and 272 FSMA to be permitted links, provided the schemes can be promoted directly to retail investors in the UK.

- 4.18 A CIS may be authorised in the UK or another EEA member state so it can be marketed only to defined and restricted categories of investors. For example, a QIS can be marketed to intermediate or market counterparty customers. Where this is the case, we believe it should be a permitted link only for policies effected by institutional policyholders, which for the purposes of our rules means trustees of defined benefit occupational pension schemes.
- 4.19 Look through – the ability to examine fully all of the layers comprising an investment – has proved to be an extremely useful tool. It allows investors, intermediaries and us effectively to bypass the issue of the legal wrapper that surrounds an asset and look through to its underlying economic characteristics. If a CIS is not authorised in any EEA member state and is not a recognised scheme under FSMA, then we will require look through to the assets held within it which will need to comply with our rules on what constitutes permitted links. The scheme will also have to comply with the high-level rules. Such unauthorised CIS will be able to account for up to 20% of a retail unit-linked fund and be available on an unrestricted basis in institutional funds.
- 4.20 Commodities and other non-financial assets such as wine and works of art are not permitted links. The CLD does not allow for the possibility of such non-financial assets being used directly as permitted links. However, NURS do allow limited investment in gold and QIS may invest in precious metals and commodity contracts. We do not believe non-financial assets should be allowed as permitted links unless they are permitted within authorised or recognised CIS as detailed above.
- 4.21 We note that the UCITS Directive allows investment in derivatives other than for the purposes of efficient portfolio management (EPM) and the parallel consultation to this on Funds of Alternative Investment Funds proposes to widen NURS' investment powers.
- 4.22 Some responses to our consultation in October 2006 (CP06/18) to allow NURS as an automatic permitted link requested that treatment be extended to QIS as well. Our view is that it is not appropriate to extend their use to investors generally as this would be inconsistent with the restrictions on marketing of these products. However, there is a case for them to be made available to institutional investors as we have defined them.
- 4.23 We recognise that institutional investors (and, for the purpose of our new rules only, trustees of defined benefit occupational pension schemes will qualify as such) are large-scale investors in unit-linked funds and they will often have a very different appetite for risk than do retail investors. We therefore propose to give them access to a wider range of assets by allowing QIS as permitted links. QIS will only be allowed as an investment in unit-linked funds on the basis that those unit-linked funds are only available to institutional investors.
- 4.24 In setting the test for what defines institutional investors we have considered who bears the direct investment risk inherent in an asset. While under-performance of an asset can have an impact on the overall financial position of a defined benefit pension scheme, it does not necessarily have a direct financial effect on the benefits of any individual member. This is because the sponsoring employer is responsible for remedying any funding gap that might emerge as a result. Although they have similar

governance arrangements in place by virtue of boards of trustees, members of defined contribution pension schemes do not have a similar buffer to protect them from the consequences of the risks inherent in a particular asset. Their benefits will be directly affected. So we have limited the definition of an institutional investor to one where the ultimate beneficiary – the pension scheme member – does not bear direct investment risk.

4.25 Equivalent funds to QIS which may only be sold or marketed to intermediate or market counterparties are available from firms operating in other EEA jurisdictions. Institutional investors are already able to invest in such funds direct. We are interested in firms' views as to whether these should also be available via linked funds on the same basis as QIS.

4.26 Where firms take advantage of these proposed changes we would expect the disclosure of the portfolio of assets to be enough to allow trustees of defined benefit occupational pension schemes to be able to discharge fully the obligations imposed on them by the Department for Work and Pensions diversification rules.

Q10: Do you agree with our proposals for those CIS to be made available to retail policyholders?

Q11: Do you agree with our proposals to extend the use of CIS to institutional investors and the restriction of their use to trustees of defined benefit occupational pension schemes only?

Q12: What are your views about extending links for institutional investors to include funds equivalent to QIS in other EEA jurisdictions?

## **Income**

4.27 Any income due, or to become due must be from assets already defined as permitted links. We believe this rule should be retained unchanged.

## **Cash**

4.28 Cash at bank and in hand will continue to be a permitted link.

## **Deposits**

4.29 The current permitted links rules refer to 'deposits' but do not define them. This gives scope for an extremely wide interpretation of what a deposit might be. This can prove to be highly unsatisfactory as it can allow firms to claim some instruments are deposits when they clearly would not be if they were regulated by a different section of our rules. We propose to use the definition of a deposit in the FSA Glossary. In addition we expect our high-level rule giving expression to Principle 8 to deal with this. So, for example, we would not expect to see a product promoted as a deposit where the interest it pays is based on a basket of permitted and non-permitted indices.

We would be interested to know if relying on Principle 8 to define a deposit will have any consequences for existing classes of products, for example, FTSE-linked capital guarantee bonds.

### **Tax recoveries**

- 4.30 In our view, best practice and TCF require unit-linked life funds to allow for tax in their unit-pricing in a way that is, as far as possible, financially neutral between firms and policyholders and between different groups of policyholders. To achieve this, firms may need to make allowance for notional tax losses on assets when it is prudent to do so. Although their use is common, such notional tax losses are not assets that are specifically permitted links under the existing rules. We intend to make it clear that using such tax loss assets is acceptable for the purpose of fair pricing.

### **Permitted derivative contracts**

- 4.31 Permitted derivative contracts can currently only be used for the purposes of EPM or the reduction of investment risk. This requirement is part of the definition of permitted derivative contract contained in Chapter 11.1 of IPRU (INS) which refers to the prudential rules in INSPRU 3.2. It reflects the condition contained within Article 23 of the CLD on the use of derivatives.
- 4.32 We propose to base permitted links rules relating to derivatives and quasi-derivatives on INSPRU 3.2 – Market risk. We propose to use a revised definition of EPM and reduction in investment risk for this purpose.

Q13: Do you agree that our proposals on derivatives and quasi-derivatives will give firms enough investment freedom on EPM and reduction in investment risk? If not, please give evidence of how the proposed rules will be unduly restrictive?

### **Index-linked benefits**

- 4.33 Only indices that meet the definition of ‘approved index’ in IPRU (INS) can currently be used as permitted links. We propose to retain the current definition.

### **Reinsurance**

- 4.34 If a firm has reinsured its linked insurance business into another insurance undertaking, it should take reasonable steps to discharge its responsibilities to its policyholders for the reinsured business. Those steps should include maintaining adequate controls.
- 4.35 It is not uncommon for a firm to offer its policyholders the option of linking part or all of their benefits to the value of units in a fund operated by another firm. This type of arrangement can only be achieved through a reinsurance treaty between the two firms which raises a number of issues.
- 4.36 First, there is an exposure to the creditworthiness of the reinsurer. The ceding firm has to be confident that it can take full credit for the reinsurance recovery on its own

balance sheet and in the policy value it quotes to its policyholder. If the reinsurer is unable to honour its obligations in full, the exposure to this credit risk will fall either on the ceding company or on the policyholder, depending on the terms of the policy. A policyholder exposed to this credit risk may not be entitled to make a claim under the Financial Services Compensation Scheme if the loss is attributable to the failure of the reinsurer.

- 4.37 Secondly, the benefits payable under the policy may be based on decisions made at the discretion of the reinsurer, a firm with whom the policyholder has no contractual relationship. This raises questions over responsibility and accountability with regard to policyholder interests.
- 4.38 The responsibility and accountability questions become even more acute if the reinsurer is a 'pure reinsurer'. Directive provisions and FSA rules do not require such a firm to maintain a 'close matching' position in respect of its linked liabilities. If the policy benefits are based on a portfolio of assets, selected at the firm's discretion, close matching provides a control framework that makes a valuable contribution to the integrity of the policy benefits. This is because the holdings of assets in the fund, and the transactions in them, are subject to an investment accounting process creating an audit trail. And if there is confidence that the assets are correctly stated there can therefore be similar confidence that the policy benefits are correctly stated. But in the absence of close matching, this one-to-one link between the assets and policy benefits is lost. Accordingly there is a need for a robust governance process associated with the determination of the assets (which may be notional) on which the policy benefits are based.
- 4.39 The issues noted above mean that the ceding firm needs to apply and maintain due diligence over the activities, decisions and use of discretion by the reinsurer in the operation of the reinsured business. To this end we propose to include a specific rule to this effect which will re-state an existing rule in a more explicit form.
- 4.40 Our proposed rules are supported by prudential rules INSPRU 3.1.57R and 3.1.58R, and the associated guidance in INSPRU 3.1.59G to 3.1.61G.

Q14: Do you agree with our approach on reinsurance?

## **Stock lending**

- 4.41 Our current definition of 'permitted stock lending transaction' refers to INSPRU 3.2.36R to 3.2.42G. We propose to retain this as the basis, but in addition, in recognition of interests of the unit-linked policyholders (whose benefits payable are directly affected by the investment decisions taken by firms with the assets in unit-linked funds) we propose further requirements. These are that the risks are transparent to unit-linked policyholders; that where the policyholder bears the whole risk they should receive the whole recompense; and, where the risk is borne outside the fund the linked fund should receive fair and reasonable recompense for the use of policyholders funds.

Q15: Do you agree with our approach to stock lending?



## **Contracts to manage the investments of pension funds**

- 4.42 Contracts to manage the investments of pension funds that are not combined with contracts of insurance covering either conservation of capital or payment of a minimum interest are exempted from most of the requirements of the current rules. They are required to comply only with the rule on permitted derivatives.
- 4.43 We are not proposing changes to this position in this CP, although we do wish to give further consideration to this matter. We would be interested to hear from firms who have entered into contracts of this type. We would be grateful for information as to their nature and whether the relevant assets are held by the firms on their own balance sheets to meet contractual liabilities. We would also be interested in views on whether there are any factors that might bring about a material change in the position.

Q16: Do you have any further comments on the proposed new rules for permitted links?

Q17: Do you believe there is a need for further guidance or case studies to support our proposed new rules?



# Compatibility Statement

## **Statutory Objectives**

1. The proposed changes to our rules will support two of our statutory objectives: the maintenance of confidence in the financial system and securing the appropriate degree of protection for consumers.

### *Market confidence*

2. Our revised rules will allow firms running linked funds to participate more fully in financial markets. They will have greater freedom in the types of assets they can use as well as greater flexibility as to the proportions of different assets allowable within linked funds. This greater access to financial markets and instruments should have the effect of boosting confidence in the linked fund sector.

### *Consumer protection*

3. We propose to distinguish between the needs of institutional and retail customers and prevent the latter from investing in linked funds with unrestricted access to a wider range of assets. This ensures there is no dilution in the current level of protection afforded to retail customers while recognising the greater appetite for risk among institutional investors.

## **Principles of Good Regulation**

4. The revised rules for long term linked business also fulfil all six of our principles of good regulation.

### *Efficiency and economy*

5. Our changes will eliminate the current bulk of waiver requests to the permitted links rules. This will reduce the workload imposed on the Central Waivers Team as well as the General Counsel and Policy divisions by the current outdated rules. This will improve our efficiency and economy.

### *Role of management*

- 6 Our proposed rules mark a decisive move in the direction of more principles-based regulation. Many of the current prescriptive rules will be replaced by more principles-based ones. Firms' senior management will have a far greater role to play in ensuring the correct levels of risk management and controls are in place to manage the business. We will therefore enhance the role of management.

### *Proportionality*

- 7 We will distinguish between the differing needs of institutional and retail customers. In doing so we will ensure there is no dilution in the protection afforded to the latter and we will bring a greater degree of proportionality to our rules.

### *Innovation*

8. The deregulatory nature of the rules will allow firms greater flexibility in both the assets they use and the way in which they use them. This will in turn support greater innovation among firms as they are able to use the greater freedom the revised rules provide to offer new financial products and services.

### *International character*

9. Our current rules may have the effect of unnecessarily diverting money from the UK to overseas territories with more liberal or permissive regimes. Our changes will help counter this effect and therefore enhance the attraction of the UK market internationally improving market confidence while maintaining protection for the consumer.

### *Competition*

10. The greater ability to distinguish between different types of customers and to innovate accordingly should have the overall effect of increasing competition among firms. They will have fewer restrictions and their senior management will have more latitude to run their linked business in the way they feel is most appropriate to their particular circumstances.

# Cost Benefit Analysis

## Introduction

1. The transition from the current permitted links regime to the provisions proposed in this CP involves some changes. This cost benefit analysis (CBA) is intended to capture the most important impacts arising from this transition. For this analysis we identify the baseline as the current position. The CBA is an analysis of the differences between this baseline and the position that will arise if the new rules and guidance are introduced.
2. The unit-linked market to which permitted links rules apply is very large. The total value of the assets in unit-linked and index-linked life and pension funds in the UK stood at about £650 billion at the end of 2005. New premiums of around £90 billion in 2004 and an estimated £110 billion in 2005 have been paid into these funds. Some 120 firms reported holding assets in respect of this business in their 2005 annual returns, the amounts ranging from £125 billion to under £100,000. As a benchmark, Money Management, May 2006, lists 3,792 separate unit-linked insurance and individual pension funds. A very diverse range of policyholders use these funds. They range from small savers with individual pensions, endowments, investment bonds and whole of life plans to large defined benefit pension schemes making multi-billion pound investments.

## Summary of key changes

3. There are two main avenues of change proposed as a result of this review:
  - introduction of principles; and
  - changes to eligible assets.

### *Changes to eligible assets*

4. The key CBA considerations here are the impacts of the wider investment opportunities on firms' portfolios and consumer choice, and likely effects on the level of consumer protection. The main changes in this area are:
  - allowing investment in property through other funds rather than only directly;

- allowing investment in property in properly functioning markets rather than only specified territories;
- allowing QIS and EEA equivalents without limit for institutional investors;
- allowing schemes approved under sections 270 & 272 of FSMA for all investors;
- allowing unauthorised CIS subject to look through without limit for institutional and up to 20% (an increase from 10%) for other policyholders; and
- removing the 10% restriction on unlisted securities.

### *Introduction of Principles*

5. The principles aim to reflect the underlying basis of unit-linked business. The aim in part is to support what Treating Customers Fairly should mean for firms in this market. As such the attempt is greater clarity of existing requirements. Introducing these principles does, however, lead to some changes in requirements. In this CBA we focus on the following changes:
  - replacing the present readily realisable test that applies to some (but not all) categories of assets which requires them to be sellable to arm's length third parties for 97.5% of market value within seven days, by a high-level principle requiring accurate valuation and realisability in a timescale enabling firms to fulfil policy obligations;
  - requiring firms to consider the economic effect ahead of the legal form of an investment; and
  - allowing notification instead of necessitating waiver requests in the case of minor non-compliance through the dissolution or suspension of individual assets etc.

### **Benefits**

6. We expect benefits to have two main drivers: annual cost savings for firms and the FSA from a substantially lower volume of waiver applications, and increased welfare for firms and customers from the capability to invest in a wider range of assets.
7. Firms engaged in unit-linked business submit a large number of waiver requests to us. In the past year we received over 180 waiver requests, approximately 95% of which were granted. The main driver for these has been the current provision that firms may invest in property directly, but not through other funds or schemes. At other times, the provision that suspending or dissolving individual assets, markets or indices automatically results in the fund being illegally constituted has also generated large numbers of waiver requests when these events have occurred. Firms that currently submit waiver applications to us would no longer have to make these submissions. A sample of firms surveyed for this analysis suggests costs for preparing and submitting an average waiver application is approximately £10,000 per application. Using the survey median figure indicates, for the total population of firms, there could be annual cost savings in the region of £1 million to £1.5million a year from not having to submit these applications.

8. The proposed changes would also reduce our costs for processing waiver applications. We estimate the resulting reduced call on resources in the supervision, legal and policy areas may lead to cost savings of around £50,000 to £100,000 per year.
9. The larger impact of the changes proposed is expected to arise from the wider range of assets that may be invested in. Firms that wished to link life products to a wider range of assets but were discouraged from doing so by the cost and delay imposed by making a waiver application, or because of informational problems, would be able to offer their customers a wider range of asset choices and investment styles. Similarly our proposals for property, unlisted securities, CIS, QIS and their EEA equivalents widen the scope of investments. Some firms surveyed for this analysis indicated that the requirement to focus on the economic effect rather than legal form of assets should also allow them to broaden their investment scope. The relaxation of the readily realisable test may also allow firms to expand their investment portfolios, which might be currently restricted due to the requirement to meet the strict obligation.
10. This widening could lead to increased sales and profits for firms. Consumers could benefit from gaining access to a wider range of assets and investment styles within their life and pension products. This could enable consumers to move to a trade-off between return and risk that they preferred. There might also be benefits from diversification.
11. FSA research (Occasional Paper 24 (2007) An Empirical Analysis of European Life Insurance Portfolio Regulation) examining regulation imposed on asset allocation of life insurance firms finds that imposing explicit limits on investment in risky asset classes, constrains portfolio diversification and distorts portfolio choice away from the efficiency frontier. This indicates potentially higher welfare is likely from the deregulatory changes proposed in the CP.
12. We attempt to assess how large this impact of the wider investment opportunities may be. But arriving at a firm conclusion from the information available is difficult. Part of the information appears to indicate that benefits from the widening may not be very large. We know that 95% of waivers in this area are already granted, non-retail consumers can already invest in QIS and unregulated CIS outside of life products, and all consumers can already invest in property through other funds outside the life-wrapper. We also understand that currently there are only eight QIS and five schemes approved under section 272 of FSMA, which is a small number compared with the population of UCITS and NURS funds which unit-linked funds are currently allowed to invest in.
13. Part of the information suggests there is the potential for benefits to be significant. The QIS designation is recent so the small number is not surprising and is likely to grow, the changes proposed also allow EEA equivalent schemes, and there are 30 s270 schemes. Firms surveyed for this analysis have indicated while they welcome the widening of eligible assets they are unable to assess with certainty how large the impact might be.

## Costs

14. Given our approach in this review, which allows a wider range of eligible assets, and elaborates the underlying basis of linked business, our analysis has not indicated that the changes will involve incremental compliance costs of material significance to firms.
15. In addition the changes should not significantly increase the risk of consumer detriment by allowing funds to be invested in a wider range of assets, including more risky assets, without consumers fully understanding these risks. All consumers already have direct access to property, and institutional consumers to QIS & unregulated CIS outside the wrapping of a unit linked life product. We understand that information asymmetry is a much greater problem for retail customers, so to prevent possible consumer detriment we have not allowed the marketing of such schemes to non-institutional customer which cannot be sold to them outside the life wrapper.
16. Approximately 5% of funds applying for waivers have them rejected under the current rules. We have explored whether there is potential for consumer detriment after our proposed policy changes. As explained above, most recent waiver requests in this area have arisen from not being allowed to invest in property indirectly. The further requirement detailing that no additional material risk should arise above investing in the property directly should prevent any increase in consumer detriment from the first. And since we will still require firms to notify us (though not automatically have to submit waiver requests) in case of the suspension or dissolution of individual assets etc, we consider we should still be able to identify instances where customers may suffer detriment. This means there should be no significant increase in risk.



# List of Questions

- Q1: Do you agree with our proposal to allow realisability to be based on the firm's obligations under its policies?
- Q2: What increase in risk to policyholders may arise from moving away from the current 'readily realisable' definition?
- Q3: Do you agree with this principle? What effect would you expect it to have on unit-linked business in practice?
- Q4: Do you agree that, with a risk-based approach to regulation, the economic effect of an asset should be the main consideration? What consequences do you foresee as a result of this requirement?
- Q5: Do you agree that all the principles achieve their purposes to afford greater flexibility to firms without added risk to consumers?
- Q6: What are the likely consequences of removing the 10% limit on unlisted securities?
- Q7: Do you agree with our proposals for the treatment of investment in land and CIS investing in land?
- Q8: Do you have any comments on the suitability of the factors we have identified as indicating a properly functioning market?
- Q9: Do you believe there are any further risks or unintended consequences arising from our rules for a properly functioning market that have not been identified?
- Q10: Do you agree with our proposals for those CIS to be made available to retail policyholders?

- Q11: Do you agree with our proposals to extend the use of CIS to institutional investors and the restriction of their use to trustees of defined benefit occupational pension schemes only?
- Q12: What are your views about extending links for institutional investors to include funds equivalent to QIS in other EEA?
- Q13: Do you agree that our proposals on derivatives and quasi-derivatives will give firms enough investment freedom on EPM and reduction in investment risk? If not, please give evidence of how the proposed rules will be unduly restrictive?
- Q14: Do you agree with our approach on reinsurance?
- Q15: Do you agree with our approach to stock lending?
- Q16: Do you have any further comments on the proposed new rules for permitted links?
- Q17: Do you believe there is a need for further guidance or case studies to support our proposed new rules?

# Draft Handbook text and Glossary

## **PERMITTED LINKS (AMENDMENT) INSTRUMENT 2007**

### **Powers exercised**

- A. The Financial Services Authority makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 ("the Act"):
- (1) section 138 (General rule-making power);
  - (2) section 141 (Insurance business rules);
  - (3) section 150(2) (Actions for damages); and
  - (4) section 156 (General supplementary powers).
- B. The rule-making powers listed above are specified for the purpose of section 153(2) (Rule-making instruments) of the Act.

### **Commencement**

- C. This instrument comes into force on [date].

### **Amendments to the Handbook**

- D. The modules of the FSA's Handbook of rules and guidance listed in column (1) below are amended in accordance with the Annexes to this instrument listed in column (2).

(1)	(2)
Interim Prudential sourcebook for Insurers (IPRU(INS))	Annex A
Interim Prudential sourcebook for Friendly Societies (IPRU(FSOC))	Annex B
Conduct of Business sourcebook (COB)	Annex C
Glossary	Annex D

### **Citation**

- E. This instrument may be cited as the Permitted Links (Amendment) Instrument 2007.

By order of the Board  
[date]

## **Annex A**

### **Amendments to the Interim Prudential sourcebook for Insurers (IPRU(INS))**

1. The provisions of rules 3.6, 3.7 and Appendix 3.2 of the Interim Prudential Sourcebook for Insurers (IPRU(INS)) are deleted in their entirety:

IPRU (INS) rule 3.6 [deleted]

IPRU (INS) rule 3.7 [deleted]

IPRU (INS) Appendix 3.2 [deleted]

2. The following definitions set out in Chapter 11.1 of IPRU (INS) are also deleted in their entirety:

*approved index* [deleted]

*approved securities* [deleted]

*collective investment fund* [deleted]

*derivative contract* [deleted]

*index linked contract* [deleted]

*internal linked fund* [deleted]

*linked assets* [deleted]

*listed* [deleted]

*market value* [deleted]

*non-linked assets* [deleted]

*permitted connected property* [deleted]

*permitted derivative contract* [deleted]

*permitted stock lending transaction* [deleted]

*property linked benefits* [deleted]

*property linked contract* [deleted]

*property linked liabilities* [deleted]

*regulated market* [deleted]

*unlisted* [deleted]

*reinsurance recoveries* [deleted]

3. The deleted text is not shown struck through.

## Annex B

### Amendments to the Interim Prudential sourcebook for Friendly Societies (IPRU(FSOC))

1. The provisions of rules 4.12(3), 4.12(4), 4.21, 4.22, 4.23 and Appendix 3 of the Interim Prudential Sourcebook for Friendly Societies (IPRU (FSOC)) are deleted in their entirety:

IPRU (FSOC)) rule 4.12(3)	[deleted]
IPRU (FSOC)) rule 4.12(4)	[deleted]
IPRU (FSOC)) rule 4.21	[deleted]
IPRU (FSOC)) rule 4.22	[deleted]
IPRU (FSOC)) rule 4.23	[deleted]
IPRU (FSOC)) Appendix 3	[deleted]

2. The following definitions set out in Chapter 7.1 of IPRU (FSOC) are also deleted in their entirety:

<i>approved index</i>	[deleted]
<i>approved securities</i>	[deleted]
<i>collective investment fund</i>	[deleted]
<i>index linked contract</i>	[deleted]
<i>index linked liabilities</i>	[deleted]
<i>internal linked fund</i>	[deleted]
<i>linked assets</i>	[deleted]
<i>linked contract</i>	[deleted]
<i>linked long term contract</i>	[deleted]
<i>listed</i>	[deleted]
<i>non linked contract</i>	[deleted]
<i>permitted connected property</i>	[deleted]
<i>permitted derivative contract</i>	[deleted]

<i>permitted stock lending transaction</i>	[deleted]
<i>property linked benefits</i>	[deleted]
<i>property linked contract</i>	[deleted]
<i>property linked liabilities</i>	[deleted]
<i>regulated market</i>	[deleted]
<i>reinsurance recoveries</i>	[deleted]

3. The deleted text is not shown struck through.



## Annex C

### Amendments to the Conduct of Business sourcebook (COB)

1. The following text should be inserted after COB 6.13 (Process for reattribution of inherited estates). The inserted text is not shown underlined.

#### 6.14 PERMITTED LINKS RULES

##### Application

- 6.14.1 R The *rules* in this section apply to *linked long-term contracts* that are *effected* by:
- (1) *insurers* other than *EEA insurers*; and
  - (2) *EEA insurers* in the United Kingdom.
- 6.14.2 R The rules in this section do not apply to:
- (1) contracts that were *effected* before 1 July 1994, and under which *linked benefits* were permitted to be determined before that date;
  - (2) contracts *effected* by an *insurer* that are *linked long-term contracts* only because the *policyholder* is eligible to participate in any *established surplus*;
  - (3) contracts *effected* by an *EEA insurer* that are *linked long-term contracts* only because the *policyholder* is eligible to participate in an excess of assets representing the whole or a particular part of the *long-term insurance fund or funds* over the liabilities, or a particular part of the liabilities, of the *insurer* as determined by the law of the *EEA state* in which the head office of the *insurer* is situated;
  - (4) contracts to manage the investments of pension funds that are not combined with *contracts of insurance* covering either conservation of capital or payment of a minimum interest, provided always that benefits under such contracts must not be determined wholly or partly by reference to the value of, or income from, or fluctuations in the value of, *derivative contracts* other than *permitted linked derivative contracts*;
  - (5) contracts *effected* before 30 June 1995, to the extent that they provide for benefits to be determined by reference to a *collective investment scheme* that was a *listed security* immediately before 1 July 1994; and
  - (6) contracts linked to *permitted units* that were *effected* before 1 February 1992, except to the extent that they relate to acts or omissions on or after that date.

### **Principles for *firms* engaged in *linked long-term insurance business***

- 6.14.3 R The *firm* must ensure that the values of its *permitted links* are determined fairly and accurately.
- 6.14.4 R The *firm* must ensure that its *linked assets* are capable of being realised in time for it to meet its obligations to *linked policyholders*.
- 6.14.5 R The *firm* must ensure that its *linked assets* are matched with its *linked liabilities* as required by the *close matching rules*.
- 6.14.6 R The *firm* must ensure that there is no foreseeable risk that the aggregate value of any of its *linked funds* will become negative.
- 6.14.7 R The *firm* must notify its *linked policyholders* of the risk profile and investment strategy for the *linked fund*:
- (1) at *inception*, and
  - (2) before making any material changes.
- 6.14.8 R The *firm* must ensure that its systems and controls and other resources are appropriate for the risks associated with its *linked assets*.
- 6.14.9 R
- (1) The *firm* must select *linked assets* having regard to the need to minimise the risk of a conflict of interest with its *linked policyholders*.
  - (2) If a conflict does arise, the *firm* must take reasonable steps to ensure that the interests of the *linked policyholders* are safeguarded.
- 6.14.10 R In applying the rules in this section, the *firm* must consider the economic effect of its *permitted links* and *linked assets* ahead of their legal form.
- 6.14.11 R The *firm* must notify the *FSA* as soon as it becomes aware of any failure to meet the requirements of this section.

### **Rules for *firms* engaged in *linked long-term insurance business***

- 6.14.12 R An *insurer* must not contract to provide benefits under *linked long-term contracts of insurance* that are determined:
- (1) wholly or partly, or directly or indirectly, by reference to fluctuations in any index other than an *approved index*;
  - (2) wholly or partly by reference to the value of, or the income from, or fluctuations in the value of, property other than any of the following:

- (a) *approved securities*;
- (b) *listed securities*;
- (c) *permitted unlisted securities*;
- (d) *permitted land and property*;
- (e) *permitted loans*;
- (f) *permitted deposits*;
- (g) *permitted scheme interests*;
- (h) income from (a) to (g) above;
- (i) cash;
- (j) *permitted units*;
- (k) *permitted stock lending*; and
- (l) *permitted linked derivative contracts*.

- 6.14.13      G      Nothing in these rules shall prevent a *firm* making allowance in the value of any *permitted link* for any notional tax loss associated with the relevant *linked assets* for the purposes of fair pricing.
- 6.14.14      R      A *firm* that has entered into a *reinsurance contract* in respect of its *linked long-term insurance business* must nevertheless discharge its responsibilities under its *linked long-term insurance contracts* as if no *reinsurance contract* had been effected.

## Annex D

1. The following text should be inserted into the Glossary<sup>1</sup>. The inserted text is not shown underlined.

*approved  
index*

in relation to *permitted links*,

- (a) an index that is:
  - (i) calculated independently;
  - (ii) published at least once every week;
  - (iii) based on constituents that are *permitted links*; and
  - (iv) calculated on a basis that is made available to the public, and that excludes both the rules for including and excluding constituents and the rules for valuation which must use an arithmetic average of the value of the constituents; or
- (b) a national index of retail prices published by or under the authority of a government of a State belonging to Zone A as defined in the *Banking Consolidation Directive*; or
- (c) an index that is:
  - (i) based on constituents that are *permitted links*; and
  - (ii) in respect of which a *derivative* contract is *listed*.

*approved  
securities*

any of the following:

- (a) any *securities* issued or guaranteed by, or the repayment of the principal of which, or the interest on which is guaranteed by, and any loans to or deposits with, any government, public or local authority or nationalised industry or undertaking that belongs to Zone A as defined in the *Banking Consolidation Directive*; or
- (b) any loan to, or deposit with, an *approved financial institution*; or
- (c) debentures issued prior to 31 December 1994 by the Agricultural Mortgage Corporation Ltd or the Scottish Agricultural Securities Corporation Ltd.

---

<sup>1</sup> NOTE TO READERS: This glossary may be moved into COB 6.14 along with the new Permitted Links rules, at the time of their ultimate publication. A number of consequential amendments to the main Glossary will also be made at that time.

<i>close matching rules</i>	for the purposes of <i>permitted links</i> , the rules in <i>INSPRU</i> 1.1.34R, <i>INSPRU</i> 3.1.57R, <i>INSPRU</i> 3.1.58R, and <i>INSPRU</i> 3.1.59R.
<i>inception</i>	in relation to <i>permitted links</i> , refers to the time when the liability of the <i>insurer</i> under a <i>linked long-term contract of insurance</i> commenced, and for this purpose, a contract providing continuous cover is deemed to commence on each anniversary date of the contract.
<i>index linked assets</i>	in relation to <i>permitted links</i> , the assets held by an <i>insurer</i> for the purposes of matching <i>index linked liabilities</i> .
<i>index linked contract</i>	a <i>linked long-term contract of insurance</i> conferring <i>index linked benefits</i> .
<i>institutional linked policyholders</i>	in relation to <i>permitted links</i> , <i>linked policyholders</i> who are trustees of a <i>defined benefit occupational pension scheme</i> .
<i>linked assets</i>	<i>index linked assets</i> or <i>property linked assets</i> .
<i>linked benefits</i>	<i>property linked benefits</i> or <i>index linked benefits</i> .
<i>linked fund</i>	a real or notional account to which an <i>insurer</i> appropriates <i>linked assets</i> for the purposes of them being <i>permitted links</i> , and which may be subdivided into units, the value of each of which is determined by the <i>insurer</i> by reference to the value of those <i>linked assets</i> .
<i>linked long-term contract</i>	a <i>contract of insurance</i> that is a <i>linked long-term contract</i>
<i>linked liabilities</i>	<i>property linked liabilities</i> or <i>index linked liabilities</i> .
<i>linked policyholders</i>	<i>policyholders</i> under a <i>linked long-term contract</i> .
<i>permitted deposits</i>	in relation to <i>permitted links</i> , <i>deposits</i> with any of the following: <ul style="list-style-type: none"> <li>(a) an <i>approved credit institution</i>;</li> <li>(b) an <i>approved financial institution</i>, or</li> <li>(c) an <i>approved investment firm</i>.</li> </ul>
<i>permitted linked derivative contracts</i>	in relation to <i>permitted links</i> , a contract involving a <i>derivative</i> or <i>quasi derivative</i> that satisfies <i>INSPRU</i> 3.2.5R to <i>INSPRU</i> 3.2.9R (inclusive) and also <i>INSPRU</i> 3.2.14R, amended as follows: <ul style="list-style-type: none"> <li>(a) <i>INSPRU</i> 3.2.6R is amended to "A <i>derivative</i> or <i>quasi-derivative</i> is held for efficient portfolio management if the <i>firm</i> reasonably believes that</li> </ul>

it (either alone or together with any covered transactions) enables the *firm* to achieve its investment objectives in a manner which includes, but is not limited to, the following..."; and

- (b) in INSPRU 3.2.6 and 3.2.7, all references to '*admissible assets*' are replaced by '*permitted links*'.

*permitted land and property* in relation to *permitted links*, any interest in land (and any buildings situated on it) provided that:

- (a) it is considered by the *firm* to be located in a territory with a properly functioning market, characterised by the following criteria:
- (i) a lack of artificial barriers, including barriers to foreign ownership and repatriation of capital;
  - (ii) fair and accurate valuation;
  - (iii) suitably qualified and independent surveyors;
  - (iv) accurate financial information;
  - (v) enforceable contractual and other property rights;
  - (vi) clarity of taxation;
  - (vii) reliable performance benchmarking;
  - (viii) ethical transaction standards, and
- (b) it is:
- (i) owned directly by the *firm*; or
  - (ii) held in a structure, or a series of structures, that do not pose a materially greater risk to *linked policyholders* than a direct holding, and
- (c) it is not geared in excess of 10% of the aggregate asset value of the *linked fund*.

*permitted links* the property in COB 6.14.12R that an insurer may use for the purposes of determining *property-linked benefits* or *index-linked benefits* under *linked long-term contracts of insurance*.

*permitted loans* in relation to *permitted links*, a loan with any of the following:

- (a) an *approved credit institution*;
- (b) an *approved financial institution*;

- (c) an *approved investment firm*; or
- (d) any person, provided that the loan:
  - (i) is documented in a written agreement setting out the rate of interest and the amount of, and due dates for, repayments, and
  - (ii) is fully secured by a mortgage or charge on *permitted land and property* that, if made to someone other than a body corporate, is not used wholly or mainly for domestic purposes.

*permitted stock lending* in relation to *permitted links*, a *stock lending* transaction (including a *repo* transaction) that satisfies *INSPRU* 3.2.36 to *INSPRU* 3.2.42G (inclusive), amended as follows:

- (a) *INSPRU* 3.2.36R(1) is deleted and replaced by the following: "For the purposes of the *rules* on *permitted links*, a *stock lending* transaction (including a *repo* transaction) is approved if:";
- (b) in *INSPRU* 3.2.36R(1)(a) the reference to "*admissible assets*" is replaced by "*permitted links*";
- (c) *INSPRU* 3.2.36R(1)(c) is deleted and replaced by the following:
  - " (c) adequate and sufficiently immediate *collateral* (*INSPRU* 3.2.38R to *INSPRU* 3.2.41R) is obtained to secure the obligation of the *counterparty*, and
  - (d) provided always that, for the purposes of *property linked assets* only:
    - (i) where the *linked policyholder* bears the whole of the risk associated with the *stock lending* transaction, they must receive the whole of the recompense (net of fees and expenses);
    - (ii) the extent of any risk that the *linked policyholders* bears in relation to the *stock lending* transaction must be disclosed to them; and
    - (iii) where the risk associated with the *stock lending* transaction is borne outside the *linked fund*, the *linked fund* should receive a fair and reasonable recompense for the use of the *linked policyholders'* funds."

- permitted scheme interests*
- (a) in respect of a firm's business with *institutional linked policyholders* only, any of the following:
    - (i) a *qualified investor scheme* or its *EEA* equivalent;

- (ii) any *unregulated collective investment scheme* that invests only in *permitted links* and publishes its prices regularly;
- (iii) any of the interests set out in (b)(i) to (b)(iv) below;
- (b) in respect of a firm's business with *linked policyholders* other than those described in (a), any of the following:
  - (i) an *authorised fund*;
  - (ii) a *recognised scheme*;
  - (iii) a *UCITS scheme*;
  - (iv) a *non-UCITS retail scheme*;
  - (v) any *unregulated collective investment scheme* that invests only in *permitted links* and publishes its prices regularly, provided that no more than 20% of the gross assets of the *linked fund* are so invested.

*permitted units* in relation to *permitted links*, units or beneficial interests in any real or notional fund that invests only in *permitted links* and is managed either:

- (a) wholly by the *insurer*, or
- (b) wholly or partly by:
  - (i) an agent on behalf of the *insurer*, or
  - (ii) a *reinsurer* in relation to a *reinsurance contract* with the *insurer*,  
for whom the *insurer* retains all responsibility towards its *linked policyholders*.

*permitted unlisted securities* in relation to *permitted links*, means any investment (including a *share*, *debt security*, *Treasury Bill*, Tax Reserve Certificate or Certificate of Tax Deposit) that is not a *listed security*, but provided always that it is realisable in the short term.

*property linked assets* in relation to an *insurer*, *long- term insurance assets* that are, for the time being, identified in the records of the *insurer* as being assets by reference to the value of which *property linked benefits* are to be determined.



2. The following text is inserted into the Glossary. Underlining indicates new text and striking through indicates deleted text.

*reinsurance contract* (in COB, ~~ICOB~~, CASS 5 and ~~COMP~~) a *contract of insurance* covering all or part of a risk to which a *person* is exposed under a *contract of insurance*.

**PUB REF: 000661**

The Financial Services Authority  
25 The North Colonnade Canary Wharf London E14 5HS  
Telephone: +44 (0)20 7066 1000 Fax: +44 (0)20 7066 1099  
Website: <http://www.fsa.gov.uk>

Registered as a Limited Company in England and Wales No. 1920623. Registered Office as above.