Consultation Paper

116

Financial Services Authority

The Interim Prudential Sourcebooks for Insurers and Friendly Societies:

Guidance on insurance group solvency (implementing the EC Directive on Insurance Groups – 98/78/EC)

November 2001

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The Financial Services Authority invites comments on this Consultation Paper. Comments should reach us by 28 February 2002.

Comments may be sent by electronic submission using the form on the FSA's website (at www.fsa.gov.uk/pubs/cp/cp116_response.html).

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It is the FSA's policy to make all responses to formal consultation available for public inspection unless the respondent requests otherwise.

1 Executive summary

1.1 This Consultation Paper seeks comments from firms, professional bodies and other interested parties on the guidance and rule amendments in Annexes B to E of this Consultation Paper about our rules implementing the EC Insurance Groups Directive (98/78/EC). Respondents to Consultation Paper 50 ('Implementing the EC Directive on Insurance Groups'), which set out our proposals for rules implementing that directive, asked for this guidance. In line with CP50, and our response Policy Statement dated May 2001, the rules are now included in the Interim Prudential Sourcebooks for Insurers and Friendly Societies that came into force on 1 December 2001. The guidance is intended to come into force on 1 April 2002.

1.2 The Insurance Groups Directive introduces new arrangements for regulating insurance undertakings within an insurance group. They focus on three main requirements:

- an adjusted-solo solvency margin test designed to ensure that an insurer's solo solvency position is not distorted by any investment it makes in a related undertaking. (That is double use of the same capital to cover risks in an insurer and its related undertakings);
- a parent undertaking solvency margin calculation designed to assess resources available to meet the overall insurance risk borne by a group; and
- monitoring of material intra-group transactions

1.3 Chapter 3 of this Consultation Paper discusses these requirements and Annexes B to D contain draft guidance on each of them in turn. Annex E sets out three draft amendments to the rules in the Interim Prudential Sourcebook for Insurers which are intended to clarify the application of those rules in line with the policy objectives set out in the draft guidance notes.

2 Introduction

2.1 Consultation Paper 50 dated May 2000 set out our proposals for implementing the EC Insurance Groups Directive (98/78/EC). We issued, after considering responses to Consultation Paper 50, a policy statement in May 2001 which included the final rules. These have now been made and included in the Interim Prudential Sourcebooks for Insurers and Friendly Societies which came into force on 1 December 2001.

2.2 Chapter 3 of this Consultation Paper discusses the draft guidance we prepared on the insurance group solvency rules and three related amendments to the rules. The text of the guidance notes and proposed rule amendments is attached in Annexes B to E. It does not represent any change to the policy objectives originally set out in Consultation Paper 50. So, this chapter and related annexes should be read with that Consultation Paper.

2.3 We invite comments from the insurance industry and its customers, from the friendly society movement and its members, and from other interested parties.

3 Insurance group solvency (implementing the EC insurance groups directive)

The adjusted-solo solvency margin test

3.1 The Insurance Groups Directive requires the solo solvency margin test set by the first, second and third life and non-life insurance directives to be adjusted to get rid of double-gearing. This is described in chapter 3 of CP50. The adjusted test, which is already like the approach used before in the United Kingdom, has been implemented by amendments to the Interim Prudential Sourcebook for Insurers and Friendly Societies (see mainly rule 4.2 – shares in a group undertaking).

3.2 Annex B of this Consultation Paper contains draft guidance notes on these amended rules. They deal with the 'down-the-chain' contribution to an insurer's solvency of undertakings in which it has an interest of more than 20% by requiring:

- an appropriate valuation of an insurer's shares in group undertakings;
- calculation of the extent to which that value represents surplus assets in the related undertaking. This is done by excluding assets which have either been allocated for other specific purposes, or represent interests in the capital of other group undertakings or are otherwise effectively unavailable to contribute to the solvency of the insurer; and
- that assets assigned for specific purposes in related undertakings are sufficient in value and suitable for the purpose.

3.3 The guidance notes are intended to explain how the rules apply in the above respects. One part of this explanation is how the rules apply to control of risk concentrations arising from the sum of asset and counterparty exposures in an insurer and its related undertakings.

Q1: Do the proposed guidance notes in Annex B adequately explain how the adjusted-solo solvency margin test works? Does Annex B explain how the new test differs from the previous requirement?

The parent undertaking solvency calculation

3.4 The EC Insurance Groups Directive introduces a new parent undertaking solvency calculation. This is described in chapter 4 of CP50. It is now included in a new chapter 10 of the Interim Prudential Sourcebook for Insurers.

3.5 Annex C to this Consultation Paper contains draft guidance notes on these new rules. They tackle the 'up-the-chain' and 'down-the-chain' valuation of members of an insurance group of which a direct insurer is part. They discuss the status of the solvency calculation; at this stage it is merely a calculation for the information of supervisors rather than a test which must show a positive result. They also discuss what information is required and the process for providing it. The guidance notes also cover the treatment of hybrid debt issued by an insurance holding company.

3.6 We are aware that different corporate structures of insurance groups and the location of the ultimate insurance parent undertaking could effect how the parent undertaking requirements apply. There are several circumstances in which it may be appropriate to modify or waive the rules (see chapter 8 of the Supervision manual) and these are highlighted in the guidance notes.

Q2: Do the proposed guidance notes in Annex C adequately explain the requirements of chapter 10 of the interim prudential sourcebook for insurers? Is it clear to whom the rules apply and which undertakings are included in the scope of the insurance group? Is the process for deciding what information is required and how it should be provided clear?

Supervision of intra-group transactions

3.7 The Insurance Groups Directive requires that competent regulatory authorities exercise 'general supervision' over intra-group transactions and receive at least annual reporting of 'significant' intra-group exposures. Chapter 5 of CP50 describes this. These requirements have been implemented in chapter 9 of the Interim Prudential Sourcebook for Insurers (see Part IV – Material connected-party transactions).

3.8 Annex D of this Consultation Paper contains draft guidance on this rule. It notes, among other things, that 'connected-party' transactions reporting is wider in scope than 'insurance group' for the parent undertaking requirements of chapter 10.

Q3: Do the proposed guidelines in Annex D adequately explain the material connected-party transactions reporting requirement?

Draft amendments to rules implementing the adjusted-solo solvency margin test and the parent undertaking solvency margin calculation

3.9 Annex E to this Consultation Paper contains three proposed amendments to the Interim Prudential Sourcebook for Insurers.

a) It contains a new rule 4.2(5). It clarifies that the option to value shares in non-insurance related undertakings at market value (rule 4.2(1)(b)(ii)) is limited to the extent that those shares can effectively be made available or realised to meet losses (if any) arising in the insurer. This was always the policy aim. In particular this clarification is intended to deal with a strategic investment in a listed company which might not be realisable at or near its market price.

b) Rule10.2(2) (a) to (d) is amended. This is to correct potential double counting of deficits in related undertakings. This may occur because the structure of a group will affect:

- how the Valuation of Assets Rules (including the surplus assets rule 4.2(2) apply; and
- how rule 5.3A which provides for deficits in insurance related undertakings, applies.

The amended drafting aims to ensure that in each case deficits in related undertakings are taken into account but not counted twice.

c) A new sentence is added at the end of paragraphs 11A and 15A of Appendix 4.2. This is to reduce the effect of those requirements which could be too burdensome. Previously drafted 11A and 15A stated that to calculate an insurer's asset and counterparty admissibility limits the total exposure of a dependant to a particular asset or counterparty must be added to the insurer's exposure to assets of the same description and same counterparty. Those limits are set as a proportion of the insurer's business amount only (with no supplementary amount being added to reflect the dependant's business amount). In contrast the contribution to an insurer's solvency of its shares in a dependant is limited to the dependant's surplus assets. The proposed amendment would limit the dependant's exposure that must be added to the insurer's exposure to that exposure that is represented in the dependant's surplus assets.

We consider that this amendment will achieve the policy objective of adequately controlling market and counterparty risk concentrations group-wide without being unduly burdensome. One concern is that the treatment of synthetic assets where local relevant regulatory requirements are used may not always ensure that these concentrations are adequately controlled. In principle we consider that this should be taken into account

when agreeing a designated state or territory. However we will monitor the effect of the amended requirement and will review it if necessary.

Q4: Do you have comments on any of the three draft rule amendments aimed at clarifying rules related to insurance groups?

4 Cost-benefit analysis

4.1 Chapter 3 and Annexes B to E of this paper give guidance and clarification amendments on the rules set out in Consultation Paper 50 (Annexes B-D). We do not consider a cost-benefit analysis is necessary since, in our view, neither the rule changes nor the guidance give rise to costs of more than minimal significance.

Q5: Do you have comments on the cost-benefit statement?

5 Compatibility statement

5.1 This chapter explains why we believe that the rule amendments and guidance proposed in this Consultation Paper are compatible with our general duties under section 2 of the Act and why they are the most appropriate way to meet our regulatory objectives. (A compatibility statement on the rules implementing the EC Insurance Groups Directive (98/78/EC) is given in chapter 9 of Consultation Paper 50.)

Compatibility with the statutory objectives

5.2 The proposed rule amendments and guidance will not have a significant direct bearing on our statutory objectives but they will have the following indirect benefits:

- they will contribute to **market confidence** by clarifying for market participants what the purpose of the rules on insurance group solvency is;
- they will contribute to the **protection of consumers** by helping firms understand how to apply the rules on group solvency;
- although the rules and guidance contained in the Interim Prudential Sourcebooks are not primarily aimed at promoting **public awareness** the explanations proposed will make the rules easier for a wider audience beyond authorised firms to understand.

5.3 The proposals in this Consultation Paper do not address our fourth statutory objective (**reduction of financial crime**).

Compatibility with the need to have regard to the principles of good regulation

5.4 **The need to use resources in the most efficient and economic way.** The proposals in this Consultation Paper are expected to contribute to the efficient and economic use of FSA resources by reducing the time that we will need to spend pursuing errors in returns.

5.5 **The responsibilities of those who manage the affairs of authorised persons.** The proposals in this Consultation Paper do not directly address senior management responsibilities. However the explanation of group solvency requirements will help senior management to perform the duties of sound and prudent management.

5.6 **The principle that a burden or restriction should be proportionate to the benefits, considered in general terms, which are expected to result from the imposition of that burden or restriction.** The proposals in this Consultation Paper are considered to be proportionate to the benefits because the explanations proposed will help firms to comply with group solvency requirements more easily and quickly.

5.7 **The desirability of facilitating innovation in connection with regulated activities.** We consider that the understanding of group solvency issues which the proposals in this Consultation Paper are designed to promote is a prerequisite to sound innovation in the insurance market.

5.8 **The international character of financial services and markets and the desirability of maintaining the competitive position of the United Kingdom.** The purpose of the Insurance Groups Directive is to ensure that European insurance undertakings have equal access to the European single market in insurance which is essential to the competitive position of the UK's insurance industry. The explanations proposed in this Consultation Paper will help UK insurers to comply with the directive. More generally the proposals will be helpful to the 'United Kingdom as a financial centre' because user-friendly regulation increases firms' confidence and lower regulatory risk makes the United Kingdom more attractive as a place to do business.

5.9 **The need to minimise the adverse effects on competition that may arise from any exercise of its general functions.** The proposals in this Consultation Paper will have minimal direct adverse effect on competition.

5.10 **The desirability of facilitating competition between those who are subject to any form of regulation by the FSA.** We believe the proposals in this Consultation Paper will promote competition by helping consistent interpretation of the requirements which will prevent some firms from gaining undue advantages over others.

The most appropriate way for the FSA to meet its regulatory objectives

5.11 We believe that the proposals set out in this Consultation Paper are the most appropriate way to meet our regulatory objectives because they provide an explanation of the rules on insurance group solvency which will enable those rules to be applied as effectively and efficiently as possible with minimum effect on innovation and competition.

Q6: Do you have comments on the compatibility statement?

Annex A

List of questions

Q1: Do the proposed guidance notes in Annex B adequately explain how the adjusted-solo solvency margin test works? Does Annex B explain how the new test differs from the previous requirement?

Q2: Do the proposed guidance notes in Annex C adequately explain the requirements of chapter 10 of the interim prudential sourcebook for insurers? Is it clear to whom the rules apply and which undertakings are included in the scope of the insurance group? Is the process for deciding what information is required and how it should be provided clear?

Q3: Do the proposed guidelines in Annex D adequately explain the material connected-party transactions reporting requirement?

Q4: Do you have comments on any of the three draft rule amendments aimed at clarifying rules related to insurance groups?

Q5: Do you have comments on the cost-benefit statement?

Q6: Do you have comments on the compatibility statement?

Guidance on implementing the adjusted-solo solvency margin test

Part I: Insurance companies

B1. The Insurance Groups Directive (98/78/EC) introduces new arrangements for the regulatory supervision of insurance undertakings within a group. A requirement of that directive is that the solo solvency margin test be adjusted to eliminate double or multiple gearing (that is the use of the same capital to support two or more businesses through investments in *related undertakings*). The following amendments to the guidance in volume 3 of the Interim Prudential Sourcebook for insurers are proposed in respect of the implementation of the adjusted-solo solvency margin test.

B2. Insert after paragraph 4.6 of Guidance Note 4.1 (Guidance for insurers and auditors on the Valuation of Assets Rules) the following:

Shares in a group undertaking (Adjusted-solo solvency margin test)

Purpose

4.7 The purpose of the adjusted-solo solvency margin test is to assess the solvency of an insurer:

- taking into account the proportionate share of net assets of its *related undertakings*, except where they are *subsidiary undertakings* and there is a deficit when the total deficit must be included;
- eliminating double-gearing whether arising from intra-group investment, reciprocal financing, intra-group holdings of unpaid share capital or otherwise; and
- including only certain assets of *related undertakings* to the extent they are available to cover the liabilities and *notional required minimum margin* of that undertaking and the *insurer*.

Application and scope

4.8 The adjusted-solo solvency margin test applies to direct *UK insurers*, UK re-insurers and UK branches of non-EEA direct insurers. It is calculated on the basis of the unconsolidated balance sheet of the *insurer* that includes a value (the 'book value') attributed to its *participations* in *related undertakings*. The book value is deducted. The balance sheet value after deduction is then aggregated with the proportionate share of the *surplus assets* of each *related undertaking* (and the proportional share of any deficit except where the *related undertaking* is a *subsidiary* when the full deficit is included). This value is then compared with the sum of the *participating undertaking's required minimum margin* and the proportionate share of the *notional required minimum margins* of the *related undertakings*.

A *related undertaking* is defined as either a *subsidiary* or an undertaking in which an insurer holds a *participation*. Thus rule 4.2 relates to the 'downward' valuation of undertakings in which an *insurer* has a holding of 20% or more (a separate requirement for an 'upward' valuation of *group undertakings* – the parent undertaking solvency calculation – is described in Guidance Note 10).

Basic calculation

4.9 The procedure for valuing shares in a *related undertaking* falls into three broad stages. First the undertaking must be valued according to rule 4.2(1). Then *surplus assets* must be identified according to rule 4.2(2). Thirdly in the process of allocating assets to cover liabilities and the *notional required minimum margin* the assets selected must be valued according to rule 4.2(3).

For the purposes of applying the adjusted-solo solvency margin test to an *insurer* the value of its holding in a *related undertaking* that is an *insurance undertaking* or *insurance holding company* is restricted to its share of the *related undertaking's surplus assets* as determined by the *Valuation of Asset Rules* but without applying admissibility limits (see rule 4.14).

Where the *related undertaking* is not an *insurance undertaking* or *insurance holding company* it may be valued either in accordance with the *Valuation of Asset Rules* (other than rule 4.14(1)(a) to (c)) or at market value as determined under rule 4.8 (see rule 4.2(1)(b)(ii)). This is intended to allow goodwill to count towards the solvency position where appropriate. However it should be noted that the value of any shares held in a group undertaking arrived at under 4.2 is a maximum value. It will not always be appropriate to use the maximum value where, for instance, the value of any shares held in a *related undertaking* which is not an *insurance undertaking* or an *insurance holding company*, is calculated by reference to 4.2(1)(b)(ii). In that event, that value should be reduced to the extent that those shares cannot effectively be made available or realised to meet losses (if any) arising in the *insurer* (see proposed rule 4.2(5)).

The option to value shares in non-insurance undertakings at market value is also available in respect of the parent undertaking solvency margin calculation (see Guidance Note 10). An *insurer* may use one option for the adjusted-solo solvency margin test and the other for the parent undertaking solvency margin calculation but where valuation differences are material the FSA should be informed of this under Principle 11.

Rule 4.2(1) prescribes only a maximum valuation of shares in a *group undertaking* which effectively allows a related *insurance undertaking* to be excluded from the adjusted-solo solvency margin test by ascribing it a nil value. It is intended that this be used where a *related undertaking* is immaterial, its inclusion would be misleading or the information required is not readily available (where a nil value is ascribed the FSA should be informed under Principle 11- openness with supervisors). However it should be noted that rule 5.3A requires that where a deficit exists in a *related undertaking* that is an *insurance undertaking* or an *insurance holding company* a provision must be made and it may not simply be valued at nil.

The effect of rule 4.3 is that the market valuation option is available only for valuing shares in a non-insurance *related undertaking* but not for valuing loans to non-insurance *related undertakings*. The reason for this is that while shares can normally be realised at the market price a loan can only be repaid from the net assets of the beneficiary and so its value for solvency purposes should not exceed that amount.

4.10 *Surplus assets* (see rule 4.2(2)) are a *related undertaking's* total assets less:

- the assets selected to cover its liabilities and its *notional required minimum margin*. As set out in rule 4.2(3) these must be valued under the rules of the *designated state or territory*, or the *Valuation of Assets Rules*.
- assets that represent holdings in the *insurer's* and the *related undertaking's* own capital, whether held directly or indirectly. Where an *insurer* has treated subordinated debt as a liability the *asset* does not need to be excluded from *surplus assets*.
- assets that represent liabilities of a *related undertaking* where those liabilities have been subordinated in the interests of policyholders.
- *profit reserves* and *future profits* in an *insurer* carrying on *long-term business insurance*. *Profit reserves* and *future profits* are the items considered in rule 2.10(5) (or equivalent), regardless of whether they are treated as *implicit items*.
- *long term insurance funds* and other similar funds including a fund that represents amounts yet to be apportioned between policyholders and for other purposes.

- unpaid share capital (whether called or otherwise), other amounts that may become due on capital, and similar amounts if those amounts are or will become due from members of the *related undertaking*.
- *assets* that cannot effectively be made available or realised to meet a solvency deficit in the *insurer*. This would include amounts subject to regulatory constraints (e.g. regulatory capital requirements or dividend limitation restrictions) and exchange control restrictions as well as minority interests. It would also include assets that cannot be realised except in the long term and which are required to cover short-term liabilities.

Other types of asset, even where excluded from the definition of *surplus assets*, may be used to cover liabilities and represent the *notional required minimum margin* where permitted by the *relevant regulatory requirements*. Similarly for a non-insurance undertaking, a value may be attributed subject to the *Valuation of Assets Rules*, to other types of asset, even where excluded from the definition of *surplus assets*. However assets that are interests in the capital of a *group undertaking*, paid or unpaid, may not be used for this purpose (see rule 4.2(3)(c)).

Where a *related undertaking* is subject to regulation under the EC directives on insurance or the regulations of another *designated state or territory*, the *notional required minimum margin* is the actual margin of solvency that it is required to hold (or, in the case of a *re-insurer*, the equivalent as if the requirement applicable to an insurer were applied to a *re-insurer*). In all other cases the *notional required minimum margin* is the *required minimum margin* that would apply if the related insurance undertaking were a UK *insurer*. However an application may be made to the FSA for a *waiver* to apply the local *relevant regulatory requirements* of another state or territory if the applicant can demonstrate that they satisfy the test of being 'at least comparable' to the standards set out in the EC directives.

Designated states and territories are EEA member states (excluding the UK), Switzerland, any state in the USA, Canada or a province of Canada, Australia, South Africa, Singapore and Hong Kong. For *related undertakings* in these states or territories the definition of *relevant regulatory requirements* allows the option to use either the local solvency requirements for insurance companies (these are also applied to re-insurance companies even if the latter are not subject to regulation in that state or territory) or the *required minimum margin* applicable to *UK insurers*. Since the UK is not a designated state the *notional required minimum margin* of a Lloyd's corporate name will be the *required minimum margin* applicable to a UK *insurer*.

Where the *relevant regulatory requirements* merely identify the categories of assets that are eligible to cover liabilities or represent the *notional required minimum margin*, the *insurer* may select which assets it actually identifies for these purposes.

Where UK rules are applied to an overseas *related undertaking implicit items* have no value in the absence of a *waiver* (see rule 2.10(5)). The FSA will normally grant a *waiver* in such cases on the strength of reasonable evidence together with appropriate actuarial approval.

Liabilities must be determined in the same manner (that is either under the rules of the *designated state or territory*, or under the *Determination of Liabilities Rules*, as the case may be). Rule 5.3A requires a provision to be made for deficits in *related undertakings* which are *insurance undertakings*. This should be shown in line 22 of forms 14 & 15 together with a supplementary note identifying the amount (reference codes 1403 & 1503).

Where a *participation* is held indirectly, via an intermediate holding company, a further adjustment is made if that intermediate holding company is an '*insurance holding company*'. The insurance holding company is treated as if it were a related *insurer* (with a nil *notional required minimum margin*). An *insurance holding company* is an undertaking which, although not itself an *insurance undertaking*, has as its main business the acquisition and holding of participations in subsidiary undertakings that are exclusively or mainly *insurers* (see Guidance Note 10.3 for further guidance).

Admissibility limits

4.11 Rule 4.2 dis-applies admissibility limits (see rule 4.14) for valuation of a *related undertaking* in accordance with the *Valuation of Assets Rules* (look through) and admissibility limits are not relevant with respect to the individual assets held by a subsidiary when the option to values shares held in that subsidiary at market value has been chosen (rule 4.2(1)(b)(ii)).

Paragraphs 11A &15A of Appendix 4.2 require the exposure of a *dependant* (defined as a subsidiary valued according to look through), to the extent that it represents the *surplus assets* of the *dependant*, to be added to an *insurer's* exposures to the same assets or counterparty for the application of admissibility limits (exposures of a *related undertaking* that is not a *dependant* are not subject to paragraphs 11A & 15A of Appendix 4.2).

An insurer's exposure to a *related undertaking* is subject to admissibility limits except where the *related undertaking* is a *dependant* (see rule 4.14(5)(f)). So a holding in a *related undertaking* which is not a *dependant* (that is an undertaking in which an *insurer* has > 20% and < 50% holding or a non-insurance *subsidiary* valued at market value) is subject to admissibility limits.

The intended purpose of paragraphs 11A & 15A of Appendix 4.2 is to ensure that restrictions apply effectively to potential market and counterparty concentrations arising from accumulation of a *dependant's* exposures with those of the *insurer*. A potential concern is that where local *relevant regulatory requirements* apply the aggregation of a *dependant's surplus assets*

for this purpose rather than its total assets may in some circumstances be insufficient adequately to control potential concentrations. This may be the case for example where synthetic assets are held. In principle appropriate treatment of such assets will be part of the assessment of candidates for *designated state or territory* status so this concern should not materialise. Nevertheless the FSA will monitor the effect of those rules and will review them if necessary.

The FSA is aware that there may be circumstances in which the result of the requirements of paragraphs 11A & 15A of Appendix 4.2 could be unduly burdensome. Admissibility limits are calculated against the *insurer's* business amount only with no recognition of a supplementary amount related to the *dependant's* business. And certain potential anomalies can be envisaged, for example if a *dependant* has an exposure to its parent *insurer* the aggregation requirement would mean that an admissibility limit would effectively be applied on the exposure of the *insurer* to itself. The FSA will monitor the practical implications of these requirements to assess whether any amendment is required in the future. In the meantime, where the FSA is satisfied that the result of the admissibility calculation is inappropriate it will be prepared to consider granting a *waiver* from the admissibility rules, subject to appropriate conditions. This is most likely to be the case where the *dependant* is another similar *insurer*. In such circumstances it may, for example, be appropriate to allow the calculation to be done on the basis of the combined business amounts of the *dependant* and the *insurer*. *Insurers* should be aware of the potential impact of these requirements on their solo-adjusted solvency. Any potential need for a *waiver* should be discussed with the FSA.

Waivers (summary)

4.12 The implementation of the adjusted-solo solvency margin test may prompt an insurer to consider the need to apply to the FSA for a *waiver* from certain rules. Areas where this may be appropriate include:

- *waiver* to allow use of local regulatory requirements for *related undertakings* subject to the requirements of a non-*designated state or territory* (see paragraph 4.10 above);
- *waiver* to allow value for an *implicit item* in an overseas *related undertaking* to which UK regulatory requirements are applied (see paragraph 4.10 above);
- *waiver* to modify admissibility rules to avoid inappropriate results arising from the treatment of a *dependant's* exposures (see paragraph 4.11 above).

4.13 Table: Treatment of share in a group undertaking (rules 4.3, 4.3, 4.14 & 5A)

Relationship of the group undertaking to the insurer	Is the group undertaking an insurance undertaking or insurance holding company?	Basis of valuation	Is the investment itself restricted under rule 4.14?	Must the underlying assets be aggregated with the insurer's exposure for admissibility purposes?	Does provision need to be made by the insurer for any deficit?
Subsidiary undertaking	Yes	Surplus assets (mandatory)	No	Yes	Yes (100%)
Subsidiary undertaking	No	Surplus assets (optional)	No	Yes	No
Subsidiary undertaking	No	Market value (optional)	Yes	No	No
Non-subsidiary	Yes	Surplus assets (mandatory)	Yes	No	Yes (pro-rata)
Non-subsidiary	No	Surplus assets (optional)	Yes	No	No
Non-subsidiary	No	Market value (optional)	Yes	No	No
Note 1		Notes 2 and 3	Note 4	Note 5	Note 6

Notes to the table (all references are to the Interim Prudential Sourcebook for Insurers):

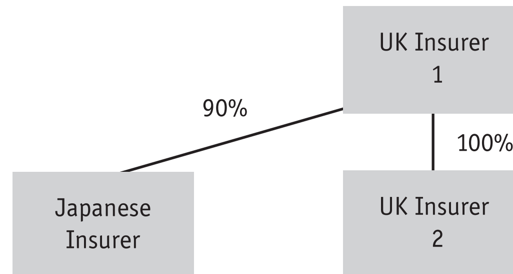
1. Rules 4.2 and 4.3 lay down rules for the value of shares in or debts due from group undertakings. Group undertakings extend, under chapter 10, to the insurer, its related undertakings, its participating undertakings and the related undertakings of its participating undertakings. Given the definition of 'related undertaking' as 'an undertaking in which a participation is held by another undertaking or which is a subsidiary undertaking' these rules therefore relate to 'downwards' companies in the group structure (i.e. from the insurer down for adjusted-solo solvency and from the ultimate insurance parent undertaking down for parent solvency – except that admissibility limits are dis-applied for the latter).
2. Rule 4.2(1)(a) requires shares in a group undertaking which is an insurance undertaking or insurance holding company to be based on its surplus assets, determined in accordance with the asset valuation rules other than rule 4.14(1)(a) to (c) which require exposure in excess of the permitted asset and counterparty limits to be deducted. In the case of shares in any other group undertaking either the surplus assets can be used, or a market value arrived at by applying rule 4.8. Insurers have a free choice as to which to use (the higher may in overall terms be disadvantageous because of the inter-relationship between this rule and the admissibility rules, and may make a different choice for the purpose of the parent undertaking solvency margin calculation provided that the FSA is informed under principle 11.
3. Although for a non-insurance undertaking there is a choice as to whether to use surplus assets or market value for the purpose of valuing shares, rule 4.3 requires a look through approach to be taken when it comes to valuing debts.
4. Rule 4.14(1) requires the asset and counterparty exposure limits to be applied to all assets of an insurer that are not exempt under (5) or (6). There is an exemption under 4.14(5)(f) for shares in or

debts due or to become due from a dependant. A dependant is defined by chapter 11 as a subsidiary undertaking, the value of whose shares is taken to be its surplus assets under rule 4.2.

5. Paragraphs 11A and 15A of appendix 4.2 require the insurer's own exposure to assets of a particular description to be increased by an amount representing the exposure, if any, of the insurer's dependants to assets of that description. The subsidiary's total exposure to assets, rather than its exposure within its surplus assets, that must be brought into account.
6. Rule 5.3A requires an insurer to make provision in respect of a related undertaking that is an insurance undertaking or insurance holding undertaking for, in the case of a subsidiary undertaking, for the whole of any deficit in the assets available to cover liabilities or represent the notional required minimum margin, and in the case of a non-subsidiary for the proportionate share of any such deficit. Related undertaking is defined by chapter 11 as an undertaking in which a participation is held by another undertaking or which is a subsidiary undertaking.

B3. Insert as new Annex C:

Example: Calculation of Adjusted-solo Solvency Margin



UK Insurers 1 and 2 will be required to perform adjusted-solo solvency margins tests (UK Insurer 2 will also be required to submit a parent undertaking solvency margin calculation on behalf of Insurer 1 – see Guidance Note 10).

Proforma Solvency Margin Calculation

Example balance sheets:

Company	Assets (excluding book value of subsidiaries)	Liabilities	RMM/Notional RMM
	£m	£m	£m
UK insurer 1	150	80	50
UK insurer 2	100	60	20
Japanese insurer	50	40	20

Step 1 – Calculate the values of subsidiaries of Insurer 1

	UK Insurer 2*	Japanese Insurer
	£m	£m
Assets	100	50
Less: liabilities	(60)	(40)
Net assets	40	10
RMM	(20)	(20)
Surplus/(deficit)	20	(10)

* This is the adjusted-solo position to be reported for Insurer 2 (assuming it has no *related undertakings*).

Step 2 – Calculate the solvency position of Insurer 1

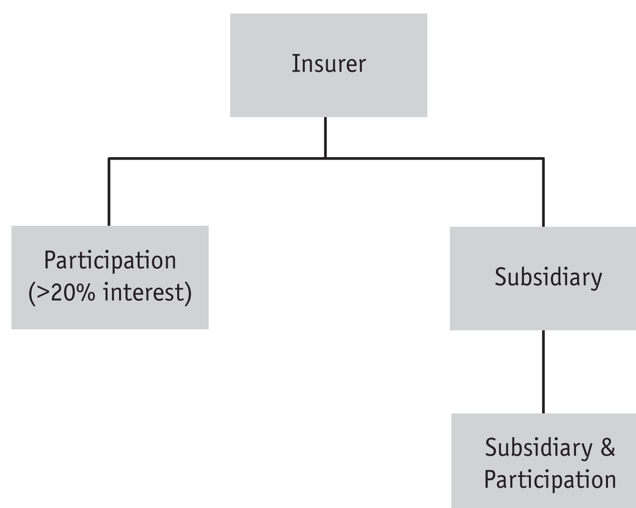
	£m	£m
Assets of Insurer 1 (excluding book value of subsidiaries)		150
Less: liabilities of Insurer 1		(80)
Net assets of Insurer 1 (excluding subsidiaries)		70
Add: surplus value of UK Insurer 2*	20	
Less: full deficit for Japanese Insurer**	(10)	
		10
Solvency surplus (deficit) for Insurer 1		80

* Admissibility limits are not applied at this level but in this example, where the *related undertaking* is a *dependant*, surplus assets would have be added to any assets of the same description/to the same counterparty held by Insurer 1 in order to calculate the admissibility of assets held by Insurer 1 (according to paragraphs 11A & 15A of Appendix 4.2).

** Where a subsidiary company has a deficit, the full value of that deficit must be brought in as a notional liability, even where the subsidiary is less than 100% owned.

B4. Insert as new Annex C.1:

Diagram: Scope of adjusted-solo solvency margin calculation



Part II: Friendly Societies

1. The Insurance Groups Directive (98/78/EC) introduces new arrangements for the regulatory supervision of *friendly societies* within an *insurance group*. A requirements of that directive is that the solo solvency margin test be adjusted to eliminate double or multiple gearing (that is the use of the same capital to support two or more businesses through investments in *related undertakings*). The following amendments to the guidance in the Interim Prudential Sourcebook for Friendly Societies are proposed in respect of the implementation of the adjusted-solo solvency margin test.
2. Insert new Annex A to Appendix 4 as follows:

Shares in a related undertaking

Paragraphs 4.7 to 4.13 of Guidance Note 4.1 in volume 3 of the Interim Prudential Sourcebook for Insurers are also relevant in respect of the valuation of shares held by a *friendly society* in a *related undertaking*.

Annex C

Guidance on implementing the parent undertaking solvency margin calculation

C1. The Insurance Groups Directive (98/78/EC) introduces new arrangements for the regulatory supervision of insurance undertakings within a group. A requirement of that directive is that a parent undertaking solvency margin calculation be performed. The following addition to the guidance in volume 3 of the Interim Prudential Sourcebook for Insurers is proposed in respect of this parent undertaking solvency margin calculation.

C2. Insert:

Guidance Note 10 (rule 10.1 & 10.2): For insurers and auditors on the parent undertaking solvency margin calculation

Introduction

10.1 This guidance relates to the parent undertaking solvency margin calculation required by the Insurance Groups Directive (98/78/EC). The calculation is analogous to the adjusted-solo solvency margin test described in paragraphs 4.7 to 4.13 of Guidance Note 4.1 but in contrast to that calculation the parent solvency calculation is applied in both an 'upward' and a 'downward' direction taking into account the net assets of the *insurance parent undertaking* and its share of the *surplus assets* of its related *insurers* and *re-insurers* and of intermediate *insurance holding companies*.

Application and scope

10.2 Under rule 10.1 the parent undertaking solvency margin calculation requirement applies only to a direct *UK insurer* which has a *parent undertaking* that is itself a direct insurance company, a re-insurance company or an *insurance holding company*. If an *insurer's* parent is none of these it will be a mixed activity holding company. This is not included in the scope of the parent undertaking solvency calculation.

10.3 An *insurance holding company* is an undertaking whose main business is to acquire holdings in subsidiaries that are wholly or mainly *insurance undertakings*. In interpreting 'main business' and 'mainly *insurance undertakings*' the factors which should be taken into account are similar to those which govern whether an undertaking prepares consolidated accounts under Schedule 9A to the Companies Act 1985 or equivalent format, for example:

- whether the main activity of the company is to acquire or hold shares and securities of *insurance undertakings* or *insurance holding companies*;
- the proportion of gross assets of the undertaking and its *related undertakings*, in *insurance undertakings*;
- the proportion of net assets of the undertaking and its *related undertakings*, in *insurance undertakings*;
- the proportion of income (being gross written premiums, turnover or other similar items) of the undertaking and its *related undertakings*, from *insurance undertakings*;
- the risk to capital within the group from the insurance operations.

10.4 Where a UK *insurer* has several *insurance parent undertakings* the parent solvency calculation requirement applies only to the *ultimate* (worldwide) *insurance parent undertaking* and the *ultimate EEA insurance parent undertaking* if different. Thus parent calculations do not have to be performed for intermediate parents. However where a UK insurer effectively has more than one *ultimate insurance parent undertakings* (e.g. in the case of a joint venture) a parent undertaking calculation should be performed in respect of both parents. In such circumstances an *insurer* may wish to contact the FSA to discuss the value of doing both calculations or whether it would be appropriate to waive one of them. Any application for *waiver* should be submitted prior to the first year-end date at which the calculation must be made.

10.5 Where several UK *insurers* have the same *ultimate insurance parent undertaking* or *ultimate EEA insurance parent undertaking* or both the parent solvency calculation requirement applies to all of them. In these circumstances agreement should be reached with the FSA which *insurer* will be responsible for submitting the information required in chapter 10 of the rules on behalf of the other *insurers* in the group. This should consist of one package of the relevant information signed by a director of each of the relevant *insurers*.

10.6 Where a UK *insurer's ultimate insurance parent undertaking* is situated in another EEA member state and it has been agreed that the competent authorities in that other member state shall be responsible for co-ordinating the parent undertaking calculation (see paragraph 10.22 & 23 below), the UK *insurer* may apply for a *waiver* to allow it to use the calculation made under the rules of that other member state for the purpose of the statement required in rule 10.2(2).

10.7 Where an *insurance group* consists of a UK *insurer* with a UK insurance subsidiary the parent undertaking solvency calculation will cover the same *group undertakings* as its adjusted-solo solvency requirement. Although the results may differ because admissibility limits will not apply to the former the subsidiary *insurer* may in these circumstances apply for a *waiver* from the parent solvency requirements (although the requirement to provide information under rule 10.2(1) would not be waived).

10.8 Even where the *insurer's* interests in *insurance undertakings* are held through a corporate structure which does not constitute an *insurance group* it may in certain circumstances give a misleading impression of the solvency of the *insurer* if the parent undertaking solvency calculation is not provided. Where this arises the *insurer* should, under Principle 11 (openness with supervisors) provide relevant information to satisfy the FSA that a risk to consumers does not arise.

Basic calculation

10.9 The methodology for the *parent undertaking* solvency margin calculation is the same as that for the adjusted solo solvency margin test except that the admissibility limits in rule 4.14(1)(a) to (c) are dis-applied. Thus the *ultimate insurance parent undertaking's surplus assets* and the *ultimate EEA insurance parent undertaking's surplus assets* (according to rule 10.2(2)(a)) are the sum of the adjusted solo surplus assets of each member of the *insurance group* (*insurance holding companies* being treated as if they were *insurers* with a nil *required minimum margin*) but with excluded excess assets added back in.

10.10 The objective of rule 10.2(2) is to require a statement of the group *surplus assets* position and an explanation of any deficits in members of the *insurance group* including information on any remedial action taken or planned. An important difference between the *parent undertaking* solvency margin calculation requirement and the adjusted-solo solvency margin test is that the former is initially only a duty to provide information rather than a formal test. If there is a negative result the explanation must include sufficient information for the FSA to determine whether this is a threat to the solvency of the *insurance group* and the related *insurers* within it. This may not necessarily be the case just as a positive result may not necessarily indicate the absence of such a threat. Thus in both instances the FSA will require background documentation on the calculation which is adequate for it to make such judgements. This will mean at least reporting surpluses and deficits at the level of each *insurance undertaking or insurance holding company* in the *insurance group*.

10.11 Notwithstanding paragraph 10.10 a positive result from the calculation is the standard that an *insurance group* is in normal circumstances expected to achieve. During the life of the interim prudential rules the FSA will consider each case according to its particular facts and will consider using its own-initiative or other

power under the *Act* where it considers a threat to a related *insurer* exists. It is intended to harden the parent undertaking calculation requirement into a formal test in the Integrated Prudential Sourcebook (see CP97).

10.12 As with the adjusted-solo solvency margin test, accounts drawn up according to local accounting rules and local regulatory requirements may be used for *designated states or territories*. Firms may apply for a *waiver* to use other relevant local rules if they can be shown to be at least equivalent to UK rules.

10.13 The FSA explained its reasons for requiring the use of aggregate unconsolidated accounts for the parent undertaking calculation in CP50. Firms may however apply for a *waiver* to use the parent's consolidated accounts (or the third – 'requirement deduction' – method allowed by the Insurance Groups Directive) but for this they will, inter alia, need to demonstrate that capital is adequately distributed within the group (this information being one of the advantages of the aggregated unconsolidated accounts method chosen by the FSA).

10.14 Where a member of an *insurance group* has a different year end to its parent and to the date at which the annual parent undertaking solvency calculation is submitted the principles of Financial Reporting Standard 2 should be followed; that is:

- where the period difference is less than three months the most recently completed financial statement should be used;
- where the period difference is greater than three months adjustments should be made for material differences.

10.15 The *Valuation of Asset Rules* permit non-insurance *related undertakings* to be valued at market value as determined under rule 4.8 (see rule 4.2(1)(b)(ii)). This is intended to allow goodwill to count towards the solvency position where appropriate. However it should be noted that the value of any shares held in a *group undertaking* arrived at under rule 4.2 is a maximum value. It will not always be appropriate to use the maximum value where, for instance, the value of any shares held in a *group undertaking* which is not an *insurance undertaking* or an *insurance holding company*, is calculated by reference to rule 4.2(1)(b)(ii). In that event, that value should be reduced to the extent that those shares cannot effectively be made available or realised to meet losses (if any) arising in the *insurer*.

10.16 The effect of rule 4.3 is that the market valuation option is available only for valuing shares in a non-insurance *related undertaking* but not for valuing loans to a non-insurance *related undertaking*. The reason for this is that while shares can normally be realised at their market price a loan can only be repaid from the net assets of the beneficiary and so its value for solvency purposes should not exceed that amount.

Hybrid debt

10.17 The FSA may, by *waiver* or *modification* of the rules, allow *insurers* to count the value of certain types of hybrid capital instruments which are issued by a *parent undertaking* that is an *insurance holding company* towards a proportion of their group's notional required minimum margin. The type of instruments that will be eligible for such treatment and the terms which such instruments should meet in order to qualify are the same as those which would apply had the issue be made by the *insurer*; these are set out in Guidance Note 2.1.

10.18 The extent to which the *waiver* may permit hybrid capital to count as pure capital as set out in paragraph 25 of Guidance Note 2.1 differs in the case of an issue by an *insurance holding company* in that the 50% and 25% limits are based on the group's notional required minimum margin. This is calculated as the sum of the group's proportional share of the *required minimum margins* of the *insurance undertakings* in the group minus any hybrid capital issued by those group members to investors outside the group (an *insurance holding company* will not itself have a *notional required minimum margin*).

10.19 If an *insurer* guarantees the issue of hybrid capital instruments by its *insurance holding company* the FSA will take the contingent liability created into account, irrespective of the way that that guarantee is accounted for under UK insurance GAAP, when assessing the adequacy of the *insurer's* financial resources and those of its *insurance group*.

10.20 The procedure that an *insurer* should follow in applying for a *waiver* from the liability arising from the issue of hybrid debt by an *insurance holding company* varies from the procedure set out in Guidance Note 2.1 only insofar as the *waiver* application should be in respect of the parent undertaking calculation in rule 10.2(2) rather than the determination of liability rules in chapter 5 of the sourcebook. Where there is more than one *insurer* in the issuing holding company's *insurance group* the *waiver* should be submitted by the *insurer* which has been allocated responsibility for providing the information required by the parent undertaking calculation (see paragraph 10.5).

10.21 The FSA will expect to be consulted at an early stage on plans *by insurance groups* to raise hybrid capital. However there is no pressing time constraint for submitting a formal *waiver* application for hybrid capital to count towards the group notional required minimum margin. The interim rules merely require an *insurer* to report the group position (with explanation of any shortfalls and remedial action) but this will not be published. For the current annual reporting round therefore it would be acceptable, subject to prior discussion with the FSA, for an *insurer* to report its group solvency position excluding any hybrid debt issued but with supplementary

information showing the proportional effect of the hybrid issue. An application for a formal *waiver* should be submitted in good time in the subsequent financial year.

EU co-ordination

10.22 A working group of EEA competent authorities has been meeting on an occasional basis with a view to developing a protocol on co-operation for the purposes of the application of the Insurance Groups Directive. This has involved allocating responsibility for co-ordinating the parent undertaking solvency requirements on a group by group basis to the supervisors in the member state in which most of a group's business is conducted. That supervisor is responsible for agreeing the calculation method and administering the parent undertaking solvency calculation in co-ordination with other relevant EEA supervisors of the group.

10.23 *Insurers* which are members of an EEA *insurance group* should contact their supervisor in the FSA to find out where responsibility for the parent undertaking calculation lies. If that responsibility lies with the UK then the *insurer* should prepare its group's parent undertaking solvency calculation in accordance with UK rules and this guidance note. If that responsibility lies with another EU member state the *insurer*:

a) may be required by a member of its group in that other member state to provide local information for the preparation of the group parent undertaking solvency calculation under the rules of that other EU member state; and

b) may apply to the FSA for a *waiver* to submit the parent undertaking solvency calculation prepared under that other member state's rules in lieu of the calculation set out in rule 10.2(2).

Waivers (summary)

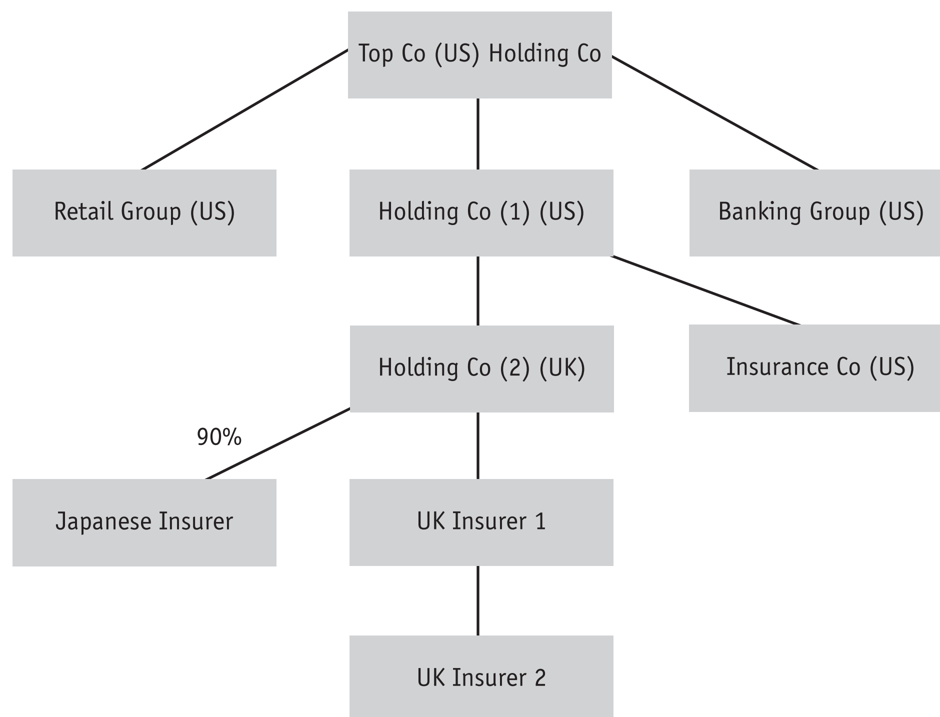
10.24 The following are areas where the FSA will commonly consider waiver applications from rule 10.2(2):

- where an *insurer* has more than one ultimate parent and FSA agrees that one or more parent calculation can be waived (see paragraph 10.4)
- where an *insurer's* ultimate parent is situated in another EEA member state and it has been agreed that the parent calculation will be done according to the rules of that member state the FSA will normally agree to accept that calculation in lieu of the calculation according to rule 10.2(2) (see paragraph 10.6)
- where an *insurance group* consists of an *insurer* with an insurance subsidiary the FSA may agree to accept the former's adjusted-solo solvency test in lieu of its parent calculation (see paragraph 10.7)

- an *insurer* may apply for a waiver to use the local rules of a country which is not a *designated state or territory* if they are at least equivalent (see rule 10.12)
- a *insurer* may apply to use a different valuation methodology (see paragraph 10.13)
- an *insurer* may apply for a *waiver* to count hybrid capital issued by its *insurance holding company* towards a proportion of its solvency requirement (see paragraph 10.17-21)

Annex A

Example : Calculation of Parent Undertaking Solvency Margin



Note: All companies are 100% owned unless otherwise indicated

UK Insurers 1 and 2 will be required to submit parent undertaking solvency margin calculations in respect of:

- Holding Co (1) – which is the 'ultimate insurance parent undertaking', and
- Holding Co (2) – which is the 'ultimate EEA insurance parent undertaking'.
- No parent undertaking solvency margin calculation is required in respect of Top Co as this is a 'mixed activity' holding company, i.e. a parent undertaking which is not itself an insurer, reinsurer or an insurance holding company (a company whose main activity is the holding of participations in insurance undertakings). If, however, the insurance activities of the Top Co group significantly outweighed the retail and banking activities, the ultimate insurance parent undertaking calculation would be carried out at the Top Co level.

Proforma Solvency Margin Calculation

Example balance sheets:

Company	Assets (excluding book value of subsidiaries)	Liabilities	RMM/Notional RMM
	£m	£m	£m
Holding Co (1)	100	90	nil
Insurance Co (US)	200	120	40
Holding Co (2)	10	60	nil
Japanese insurer	50	40	20
UK insurer 1	150	80	50
UK insurer 2	100	60	20

The parent solvency position needs to be calculated from the bottom of the group upwards.

Step 1 – Calculate the values of subsidiaries of Holding Co (2)

	UK Insurer 2	UK Insurer 1 excluding UK Insurer 2	UK Insurer 1 including UK Insurer 2	Japanese Insurer
	£m	£m	£m	£m
Assets	100	150	170*	50
Less: liabilities	(60)	(80)	(80)	(40)
Net assets	40	70	90	10
RMM	(20)	(50)	(50)	(20)
Surplus (deficit)**	20	20	40	(10)

*Assets of UK Insurer 1 of £150m plus surplus in UK Insurer 2 of £20m

** Asset and counterparty limits are dis-applied in the parent calculation. When excess assets have been excluded in the surpluses of insurer 1 and 2 they should be added back in.

Step 2 – Calculate the solvency position of Holding Co (2)

	£m	£m
Assets of Holding Co 2 (excluding book value of subsidiaries)		10
Less: liabilities of Holding Co 2		(60)
Net assets of Holding Co 2 (excluding subsidiaries)		(50)
Add: surplus value of UK Insurer 1	40	
Less: Full deficit for Japanese Insurer*	(10)	
		30
Solvency surplus/(deficit) for Holding Co 2		(20)

* Where a subsidiary company has a deficit, the full value of that deficit must be brought in as a notional liability, even where the subsidiary is less than 100% owned.

Step 3 – Calculate the values of the direct subsidiaries of Holding Co (1)

	Holding Co (2) (see above)	US Insurer
	£m	£m
Assets	40*	200
Less: liabilities	(60)	(120)
Net assets	(20)	80
RMM	nil	(40)
Surplus/(deficit)	(20)	40

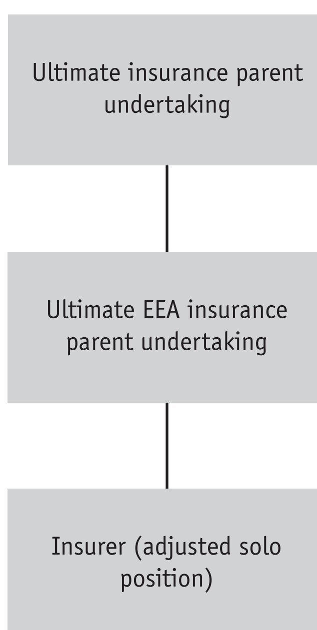
*Assets of Holding Co 2 of £10m plus values of participations in subsidiaries of £30m.

Step 4 – Calculate the solvency position of Holding Co (1)

	£m	£m
Assets of Holding Co (1) (excluding book value of subsidiaries)		100
Less: liabilities of Holding Co (1)		(90)
Net assets of Holding Co (1) (excluding subsidiaries)		10
Add: surplus value of UKS Insurer 1	40	
Less: deficit for Holding Co (2)	(20)	
		20
Solvency surplus/(deficit) for Holding Co (1)		**30**

Annex B

Diagram: Scope of Insurance Group



Guidance on implementing supervision of intra-group transactions

Part 1: Insurance companies

D1. The Insurance Groups Directive (98/78/EC) introduces new arrangements for the regulatory supervision of insurance undertakings within a group. A requirement of that directive is to report significant intra-group transactions. The following amendments to the guidance in volume 3 of the Interim Prudential Sourcebook for Insurers are proposed in respect of implementing supervision of intra-group transactions.

D2. Insert new section 20 at end of Guidance note 9.1 (Preparation of returns) as follows:

20. MATERIAL CONNECTED-PARTY TRANSACTIONS

20.1 Rule 9.39 requires every *insurer* to provide a supplementary note to Form 20 (for *insurers* carrying on *general insurance business*) and to Form 40 (for *insurers* carrying on *long-term insurance business*) describing *material connected-party transactions*. The reference codes should be 2007 and 4009 respectively.

20.2 It should be noted that the scope of *connected* party is wider than that of the *insurance group* to which the parent undertaking solvency margin calculation (according to chapter 10 of the rules) applies. A *connected* party includes the *related undertakings* (subsidiaries and participations) of the *insurer*; the immediate, intermediate and ultimate parent undertakings of the *insurer*; and the *related undertakings* of the immediate, intermediate and ultimate parent undertakings of the *insurer*. A *connected* party may also be a natural person in place of any of the parent undertakings noted above (see definitions).

20.3 A *connected party transaction* is defined as 'the transfer of assets or liabilities or the performance of services by, to or for a *connected* party irrespective of whether a price has been charged'. As such it includes (but is not limited to):

- loans and similar advances to or from a *connected* party, including inter-company balances and other such operating arrangements,
- investments in the securities of the *connected* party purchased by the *insurer*,
- investments in the securities of the *insurer* purchased by the *connected* party,
- guarantees issued to the *connected* party by the *insurer* (and other similar off-balance sheet transactions), or vice versa,
- reinsurance cessions to and acceptances from the *connected* party,
- agreements to share the costs of the *connected* party, or to share the costs of the *connected* person with a third party,
- payment of commission (including profit-commission and commission on reinsurance premiums) and other acquisition costs to the *connected* person,
- transfer of property to or from the *connected* party, including investments, land, equipment and debts, and
- transfer of liabilities to or from the *connected* party, including transfers of business under s105 of the Act.

20.4 As set out in paragraph 20.3 the price charged (if any) does not necessarily determine whether the transaction is a *connected party transaction*. Also, *connected-party transactions* include a series of transactions that may include intermediate stages with third parties but have the overall form of a transaction as defined by *connected-party transaction*.

Materiality

20.5 The materiality of transactions is determined by reference to the *long-term business amount* for transactions relating to *long-term insurance business*, and the *general business amount* for all other transactions.

20.6 Similar transactions are material (for the purposes of rule 9.39) if when combined they exceed 5% (in terms of price or value) of the *long-term business amount* or *general business amount* as applicable. Similar transactions are those of the same type with the same *connected* party. Transactions would be considered to be of the same type if they were combined in the same heading in the *profit and loss account*, balance sheet or note to the financial statements of the insurer, or form part of a connected series of transactions. However, other groups of transactions may be considered as similar even if they do not meet the above criteria.

Aggregation of disclosure

20.7 Rule 9.39(3) allows (but does not require) transactions with the same *connected* party to be disclosed on an aggregated basis unless separate disclosure is needed for a proper understanding of the effects of the transactions upon the financial position or profitability of the *insurer*.

20.8 Similar transactions (as described in 20.6) may be aggregated, for instance all reinsurance premiums paid to a *connected* party may be aggregated. However, different types of transaction may not be appropriate for aggregation, for instance aggregating loans to a *connected* party with equipment sold to that *connected* party is not allowed.

20.9 Transactions with different *connected* persons of the same type may not be aggregated. For instance, commissions paid to two or more *connected* parties may not be aggregated.

20.10 It should be noted that rule 9.39 does not allow exemption from disclosure similar to that offered under Financial Reporting Standard No8 'Related Party Disclosures' where the results of the *insurer* and *connected* party are reported in consolidated financial statements.

Disclosure

20.11 The information to be disclosed is set out in rule 9.39(2). The disclosure should be adequate to allow the reader of the Annual Return to understand the nature of the relationship of the *insurer* with the *connected* party, and the nature of the transaction and its effect upon the financial position and the profitability of the *insurer*.

20.12 Therefore, disclosure should include the transactions during the period and any amounts unpaid or outstanding in respect of those transactions at the end of the period.

20.13 Consistent descriptions of transactions should be used in subsequent Annual Returns.

20.14 The name of each *connected* party should be stated in full.

Part II: Friendly Societies

1. The Insurance Groups Directive (98/78/EC) introduces new arrangements for the regulatory supervision of *friendly societies* within an *insurance group*. A requirement of that directive is to report significant intra-group transactions. For the purpose of implementing supervision of intra-group transactions the following amendment to the Interim Prudential Sourcebook for Friendly Societies is proposed.

2. Insert in brackets after the title 'Intra-group transactions' which follows paragraph 5.24 in Chapter 5 (Prudential Reporting) the following:

   '(see section 20 of Guidance Note 9.1 in volume 3 of the Interim Prudential Sourcebook for Insurers for guidance on reporting of intra-group transactions)'.

Annex E

Amendments to rules in the Interim Prudential Sourcebook for Insurers implementing the adjusted-solo solvency margin test and the parent undertaking solvency margin calculation

IPRU(INS) Chapter 4 (Valuation of Assets)

E1. A new rule 4.2(5) should be inserted as follows:

‘Where the value of any shares held in a *group undertaking* which is not an *insurance undertaking* or an *insurance holding company* is calculated by reference to 4.2(1)(b)(ii) that value must be reduced to the extent that those shares cannot effectively be made available or realised to meet losses (if any) arising in the *insurer*.’

IPRU(INS) Chapter 10 (Parent undertaking solvency margin calculation)

E2. Rule10.2(2) (a) to (d) should be replaced as follows:

‘(2) (a) the value as determined in accordance with the *Valuation of Assets Rules* (other than rule 4.14(a) to (c)) of its *surplus assets*, less:

(i) provision for related undertakings valued on the basis of rule 5.3A (except to the extent already included in the value of *surplus assets*), and

(ii) where there are no surplus assets the amount of the deficit in the assets available to cover any liabilities not already provided for, and

(iii) the *notional required minimum margin* if any of the *ultimate insurance parent undertaking* or as the case may be the *ultimate EEA insurance parent undertaking*.

(2) (b) if the result of the calculation in (a) is negative a statement of the reason why such deficit has arisen and of any remedial action taken or planned.’

IPRU(INS) Appendix 4.2

E3. A new sentence should be added at the end of paragraphs 11A and 15A as follows:

> 'In this context exposure only includes *surplus assets* as defined in the *Valuation of Assets Rules*.'