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Financial Services Authority

Integrated Prudential sourcebook for insurers

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This Policy Statement reports on the main issues arising from Consultation Paper 190 (*Enhanced capital requirements and individual capital assessments for non-life insurers*), Consultation Paper 195 (*Enhanced capital requirements and individual capital assessments for life insurers*) and the audit and reviewing actuary proposals in Consultation Paper 202 (*Insurance regulatory reporting – changes to the publicly available annual return for insurers*) and publishes the associated Handbook text.

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Copies of this Policy Statement are available to download from our website – www.fsa.gov.uk. Alternatively, paper copies can be obtained by calling the FSA order line: 0845 608 2372.

1 Overview

- 1.1 This Policy Statement sets out our policy for inclusion in the Integrated Prudential Sourcebook (PSB) for life insurers and non-life insurers. The PSB is a single sourcebook that brings together our prudential requirements for banks, building societies, investment firms, and insurers, including directive friendly societies. The PSB includes rules and guidance on provisioning for liabilities and on capital requirements.
- 1.2 We consulted on the PSB policy for insurers in Consultation Papers (CPs) 97, 136, 143 and most recently in CPs 190 and 195. This PS confirms the overall thrust of our policy, explains amendments made following consultation and gives feedback on the responses that we received to CPs 190 and 195. It also contains a complete package of 'near final' PSB capital and provisioning rules and guidance for insurers, as well as associated changes to rules and guidance in other parts of the Handbook, such as the Supervision manual (SUP), that will also apply from 31 December 2004.
- 1.3 The PSB rules and guidance are intended to help achieve our statutory objectives of consumer protection and maintaining confidence in the financial system. They aim to do this by helping to reduce the risk that a firm cannot meet its liabilities as they fall due because it has insufficient financial resources. While our rules and guidance help to reduce the risk of financial failure, they do not reduce the risk to zero.
- 1.4 The powers that we have to make these rules and guidance are contained in sections 138, 141, 149, 156, 157 and 340 of the Financial Services and Markets Act (FSMA).

Who should read this PS?

- 1.5 This Policy Statement is of most interest to those in insurers who are responsible for ensuring their firms' compliance with our prudential requirements, analysts, and those auditing firms' returns. Other readers, including policyholders and

their advisers, may be interested to understand at a higher level how we have changed the way in which capital requirements are assessed and what the effects of the changes are. These readers are likely to find paragraphs 1.6-1.22 of this Overview section of most interest.

The Future Regulation of Insurance Review

- 1.6 During 2002 we conducted a review of the regulation of the insurance sector – *The Future Regulation of Insurance Review*¹. One outcome was confirmation of our intention to amend the current approach to setting prudential standards for insurers. The current provisioning and capital requirements for *non-life* insurers, based on European Directive requirements, are widely regarded as too low and not sufficiently risk responsive. So, we consulted in CP190 on proposals to update and improve non-life requirements, to help ensure that firms hold financial resources reflective of their individual business and control risks. Through CP195 we consulted on proposals to update requirements for *life* insurers, including proposals intended to address deficiencies in current methods of assessing an appropriate amount of capital to back with-profits business. As part of these changes, for both life and non-life firms, we proposed to introduce an individual capital adequacy framework (ICAS). The ICAS framework would require each firm to self-assess what an appropriate amount of capital would be for their business and to hold that amount of capital, and would allow us to give firms individual capital guidance.

What will change for non-life insurers?

- 1.7 CP190 proposed that while non-life insurers would need to continue to comply with current European Directive requirements (which we proposed to implement in the PSB as the Minimum Capital Requirement, or MCR) they would also be required to calculate an Enhanced Capital Requirement (ECR) and asked to report the result privately to the FSA. CP190 proposed detailed rules and guidance on how this should be done. In the past we have addressed deficiencies in Directive-based capital requirements by applying an informal rule of thumb that non-life insurers should hold capital at a level of two or more times the EU requirement. The ECR is intended to provide a risk-responsive, but standardised, method for benchmarking non-life firms' capital requirements, and will be used in ICAS discussions with firms.

1 The future regulation of insurance – Building the new regulator: Progress report 3 (October 2002)

Calculating the ECR

- 1.8 The ECR is a separate calculation of capital needs, carried out alongside the MCR. The ECR calculation requires a non-life firm to multiply the balance sheet values of its assets and liabilities, and its net premium income, by appropriate percentage risk weights. The risk weights vary for different types of assets and according to the different classes of insurance business undertaken by the firm.

Confirming the non-life ECR as a private reporting requirement

- 1.9 Responses to CP190 were supportive of our proposals and this Policy Statement confirms our intention to require non-life firms to calculate an ECR and to ask them to report it to us privately, though there have been some minor changes to the method. Further information on these changes can be found in Chapter 2.
- 1.10 This PS also confirms that, as we proposed, non-life firms' ECR calculations will be used as a starting point in our discussions with them about their individual capital assessments (ICAs), and when we give individual capital guidance (ICG). But, for the time being, the ECR will not be a binding capital requirement. We will review by 2006 whether the non-life ECR should become a hard capital requirement and will re-consult if we propose to make that change.

What will change for life insurers?

- 1.11 CP195 consulted on ECR proposals for life insurers and on how the ICAS framework should be applied to that sector. The ECR proposals set out a 'twin peaks' approach to determining appropriate balance sheet provisions and capital requirements for with-profits business. The ICAS framework would apply to all the business of a life insurer, whether with-profits, or non-profit.

The ECR

- 1.12 CP195 proposed that required capital for life non-profit business would comprise current mathematical reserving and solvency requirements based on EU Directives, subject to a few amendments such as reclassifying the resilience reserve as a capital requirement. However, for with-profits business, firms with with-profits liabilities over £500 million would hold capital based on the higher of a regulatory peak and 'realistic' peak ('twin peaks').
- 1.13 For with-profits business in twin peaks firms, the regulatory peak would represent a 'prudent' actuarial assessment of the financial resources required to meet contractual guarantees only. However, the mathematical reserves would include implicit margins for adverse deviation from the expected

position, and the EU solvency margin and a resilience requirement would be held in addition. The ‘realistic peak’ would represent an assessment of ‘expected’ liabilities arising from contractual guarantees and a fair provision for expected discretionary payments, such as future annual and terminal bonuses. In addition a firm would calculate an explicit risk capital margin on top of realistic provisions, to help address the risk that market and economic conditions may not turn out as expected: assets may be of lower value, or liabilities higher.

The effect of our changes and the reasons for making them

- 1.14 We expect that under most market conditions, a twin-peaks firm’s capital requirement for its with-profits business will be the ECR, reflecting the realistic assessment. The purpose of making changes to requirements for with-profits business was two-fold.
- 1.15 First, we wanted to link more closely than formerly a firm’s calculation of its capital requirement to how it manages its with-profits fund in practice. So, for example, the basis on which provisions for future liabilities are calculated is now required to align with a firm’s stated principles and practices of financial management (PPFM) and should include fair allowance for what the firm expects to pay as final bonuses. This also has the effect of making with-profits provisions more responsive to changes in the values of the assets backing the fund.
- 1.16 Second, our changes improve the clarity of the strength of the with-profits fund and improve comparability of results between firms:
 - the amount of capital that is surplus to provisions for expected liabilities is more transparent (its net asset position); and
 - the capital required to cover the explicit risk capital margin (RCM) reflects how the net asset position would change under a specified stress scenario.
- 1.17 Aligning the basis on which a firm calculates its with-profits provisions with its PPFM helps to ensure that both contractual or guaranteed payments and discretionary payments that policyholders have been led to expect are explicitly addressed. In addition we have explicitly linked our prudential requirements to the regulatory requirement to treat customers fairly, and we have consulted in CP207² on rules and guidance to underpin this. Our rules also recognise that fair treatment of policyholders will depend on the context, and that what a policyholder may reasonably expect in the way of bonus payments may vary according to prevailing market and economic conditions.

2 CP207: *Treating with-profits policyholders fairly* (December 2003)

Smaller with-profits firms

- 1.18 Smaller with-profits firms, are not required to adopt twin peaks, but may opt to do so. If they do not opt to adopt the twin peaks approach, they would calculate the MCR only, though their mathematical reserves for conventional with-profits business will continue to be calculated according to the 'net premium rule', as under current IPRU requirements. So, for these smaller firms, mathematical reserves would continue to address contractual guarantees, would include margins for adverse deviation, and an implicit allowance for future discretionary benefits. However, smaller firms, like twin peaks firms, are being required to improve on current IPRU methods of assessing the value of options in contracts. More modern, market-consistent methods that take adequate account of 'time value' will be required in the PSB. These reflect the fact that options that are currently only slightly in the money, or even out of the money, may yet become more valuable in future, if circumstances change.

We are confirming the twin peaks approach

- 1.19 This policy statement broadly confirms the proposals on which we consulted in CP195. There was widespread support for the proposals and considerable useful technical comment on them
- 1.20 As life insurers will no doubt agree, we consider that the timetable for developing a robust, realistic method for assessing capital for with-profits business has been challenging, and any extension of such an approach to life non-profit business would require further work. The decision to concentrate initially on the development of a realistic method for with-profits business reflects two needs. First, is the need to address the deficiencies in current reserving requirements that were identified in the *Baird Report*³ and the *Penrose Report*⁴ after Equitable Life problems. Second is the need to address issues arising from depressed equity market conditions in 2002 and early 2003, such as the technical selling of equities by firms trying to ensure less responsive IPRU solvency requirements were not breached.
- 1.21 For both these reasons, we do not consider that it would be appropriate to hold up implementation of these reforms to extend twin-peaks to non-profit business.
- 1.22 We will review whether to extend the realistic approach to non-profit business at a subsequent stage, and whether to mandate that small firms must adopt a twin peaks approach. We will consider any intervening developments in domestic and international accounting standards, and the likely timetable for Solvency 2, as part of that decision. We would re-consult on any proposals to change current policy.

3 The regulation of Equitable Life from 1 January 1999 to 8 December 2000: An independent report prepared by Ronnie Baird, Director Quality Assurance and Internal Audit, FSA (September 2001)

4 Report of the Equitable Life Inquiry, The Right Honourable Lord Penrose (March 2004)

Changes to the twin peaks approach

- 1.23 We have made some changes and clarified some of the detailed requirements of the twin peaks approach, though broadly it remains as we proposed. In summary we have:
- clarified the exclusion of future annual reversionary bonuses from mathematical reserves for twin-peaks firms, as discretionary benefits are addressed in the realistic peak;
 - clarified the treatment of non-profit business and recognition of embedded value in the realistic peak;
 - provided further guidance on the market-consistent valuation of options;
 - changed the calibration of the RCM in the light of further actuarial work; and
 - changed the credit risk test in the RCM
- 1.24 Further, more detailed, information on these changes can be found in Chapter 3, as can a discussion of the appropriate risk-free valuation interest rate for the realistic peak.

Cost benefit analysis and compatibility statements

- 1.25 Chapter 8 contains a cost benefit analysis (CBA) for those proposals that we have changed since CP195. Changes to proposals in CP190 have not been sufficiently significant to alter materially the CBA in that document. Although we are making some changes to CP195 proposals, they do not fundamentally change our objectives, or our approach. So, there is no need to change our explanation in Annex 2 of CP195 of how our rules and guidance:
- are compatible with our regulatory objectives;
 - are the most appropriate way of meeting our objectives; and
 - take account of the principles of good regulation in section 2(3) of FSMA, including that they are proportionate to the benefits expected to result.

Structure of this Policy Statement

- 1.26 Chapters 2 and 3 of this policy statement give an overview of our final ECR policy for non-life and life firms and highlight the main changes in the near final PSB text compared with CP190 and CP195 ECR proposals. Chapters 4 and 5 similarly give an overview of final policy on the definition of capital and ICAS and any changes from proposals CP 190 and CP195. Chapter 6

covers audit, actuarial report, and directors' report changes that were proposed in CP195 and CP202⁵ and sets out how these have altered. Chapter 7 covers the realistic reporting forms for life insurers.

- 1.27 The Annexes and Appendices contain more detailed material to which we refer in these chapters. In particular, Appendix 1 contains the near final Handbook text. And Annexes, numbered to correspond with the main Policy Statement chapters, give feedback on the responses that we received to specific questions asked in CP190 and CP195. Annex 9 gives high level comments on changes to PSB text that were not consulted on in CP190 or CP195, but which are reflected in the text in Appendix 1.

Next steps

When firms will need to implement the PSB

- 1.28 In order to implement the PSB for insurers we will need formally to 'make' and bring into force the rules and guidance. We intend to make the final PSB text in November, to come into force on 31 December 2004. The final PSB text will be substantially similar to the text attached to this Policy Statement. In the next few months, we will conduct further work to ensure that the final PSB text is an adequate legal expression of the FSA's policy. We expect that, and will work to ensure that, this refinement of the final PSB text will not entail material change in our policy as expressed in the text attached to this Policy Statement and elsewhere. Accordingly, we consider that the text we have included is clear enough in its intention for firms to use as a basis for preparing for PSB implementation. So, firms will be required to complete their annual returns for financial years ending on 31 December 2004, or after, on the basis of PSB rules and guidance.
- 1.29 'Near final' PSB rules and guidance on prudential systems and controls for insurers, and firms in other sectors, were published in October 2003⁶. This text will also come into force from 31 December 2004.

Transitioning from the IPRUs

- 1.30 We also need to consult on, and confirm, arrangements for 'switching off' those aspects of the IPRU rules and guidance which are superseded by the PSB. There are some aspects of the IPRU which will remain in force for the time being as they are not superseded by the PSB: rules and guidance relating to

5 CP202: *Insurance regulatory reporting – changes to the publicly-available annual return for insurers* (September 2003)

6 *Integrated Prudential Sourcebook – near-final text on systems and controls* (October 2003)

annual reporting; text relating to permitted links; and capital and other requirements for non-Directive friendly societies. We will consult on these arrangements in our next quarterly CP, to be published at the end of July 2004, including:

- transitional arrangements;
- minor modifications to the annual return to make it PSB-compatible; and
- how we propose to treat any S148 waivers and modifications of IPRU requirements.

- 1.31 Any changes to IPRU text resulting from this work would also be ‘made’ at the November board and brought into force in December 2004, to align with the PSB timetable.

Lloyd’s of London

- 1.32 We expect to extend the application of the PSB to Lloyd’s of London from 1 January 2005. We are currently consulting on this in CP04/7⁷.

Implementing changes to the directors’ certificate, annual audit requirements and appointed actuary regime

- 1.33 PS167⁸ and CP202 proposed changes to the directors’ certificate on the annual return. They also brought life insurers’ provisions for policyholder liabilities within the scope of the audit of the annual return, ended the current Appointed Actuary regime, and introduced a separate public reviewing actuary’s report. CP195 proposed extending the audit scope to include realistic numbers for with-profits business. Our final policy confirms the change to an audit report covering the whole of a life firm’s balance sheet, but we will no longer require a separate reviewing actuary’s report to be published, as this work will be covered by the audit opinion. So, the audit report has been revised to clarify that the reviewing actuary’s work falls within the audit scope and that the audit therefore encompasses a firm’s disclosures in its valuation report of the main methods and assumptions adopted for provisions and capital calculations. Explicit reference will have to be made to the fact that the auditor has sought advice from a reviewing actuary. A further, more detailed, discussion of the reasons for, and the effect of, these changes can be found in Chapter 6, and the relevant ‘near final’ Handbook text is in Appendix 1. In line with the PSB timetable, we intend that these changes will be brought into force in December 2004.

7 CP04/7: *Lloyd’s: integrated prudential requirements and changes to actuarial and audit requirements* (April 2004)

8 PS167: *with profits governance and the role of actuaries in life insurers – Feedback on CP167, made and near final text* (June 2003)

Treating with-profits policyholders fairly rules and guidance

- 1.34 In CP207⁹ we consulted on proposed rules and guidance on treating with-profits policyholders fairly (TPF). These covered matters such as the determination of amounts payable under with-profits policies and the approach to surrender values and could largely be viewed as the codification of principles that have traditionally underpinned good practice in operating with-profits business. These rules and guidance are designed to give firms greater clarity on what the obligation to treat customers fairly (which is imposed in the Principles for Businesses) means as regards with-profits business. While there was much agreement with the objectives of our consultation proposals, we received many comments on the practical application of our proposed rules and guidance at a more detailed level. As a result, and in the interests of both consumers and the industry, we have decided to re-consult on some changes in the draft Handbook text in July 2004. As well as seeking views on the changes we have made to our proposals, we will also be seeking views on the implementation timetable.

Group capital requirements and adjusted solo requirements

- 1.35 We consulted on our proposed implementation of group capital requirements stemming from the Insurance Groups Directive and the Financial Groups Directive, and our proposed draft PSB text on adjusted solo requirements, in CP204¹⁰. We expect to publish a policy statement setting out our final policy on group requirements and adjusted solo requirements in July 2004. The associated 'near final' PSB text (PRU 8.3) will be appended to that statement.

CONSUMERS

The policy changes in this paper may affect consumers, as they change the required capital that firms must hold to support their policyholder liabilities. The intention is to make a firm's capital requirement more reflective of the manner in which the management is running the business in practice, and of the risk in that business. In addition, the ending of the Appointed Actuary regime and the changes to the audit scope for life insurers:

- **make it clearer than before that the senior management of a firm have principal responsibility for ensuring that it has adequate capital; and**
- **ensure that provisions for liabilities to policyholders are now subject to independent audit review.**

9 CP207: *Treating with-profits policyholders fairly* (December 2003)

10 CP204: *Financial Groups* (October 2003)

2 Final policy on non-life ECR

- 2.1 This chapter gives an overview of our final policy on the ECR for non-life firms and any material changes from CP190 proposals. Feedback on the responses we received to the specific questions asked in CP190 is given in Annex 5 of this PS. Much of the comment that we received related to respondents' views of changes that should be made to the calculation were we to implement the ECR as a 'hard' capital requirement. We have already stated in Chapter 1 our intention to re-consult if we propose to change to a 'hard' ECR.

Overview of final of policy

- 2.2 We received 51 responses to CP190. A wide range of non-life insurers responded to the CP, along with a number of insurance industry trade associations and professional advisers. Most responses were supportive of the principle of risk based capital requirements, but felt that the ECR formula was not sufficiently sensitive to distinguish appropriately between different asset and insurance risks. They considered that, if imposed as a 'hard' capital requirement, it may result in a capital sum that did not accurately reflect the risks of their business. Many respondents highlighted the potential impact that introducing CP190 proposals ahead of Solvency 2 could have on the international competitiveness of UK insurers. Finally, many smaller insurers believed that our proposal to calibrate the ECR on the basis of a diversified book of business, and give small firms ICG higher than their ECR (to reflect lack of diversification), would place them at a competitive disadvantage.
- 2.3 We confirm our consultation proposal that, for the time being, firms will be required calculate the ECR and asked to report it privately to us. And firms will not automatically be required to hold the amount of capital indicated by the ECR calculation. However, we do consider that the ECR is a useful benchmark, and we will use it as a starting point from which to judge an individual firm's capital needs. So we will use it in applying the ICAS framework:

- when considering the appropriateness of a firm's own individual capital assessment (ICA); and
- when we give individual capital guidance (ICG).

It will for these purposes remain calibrated as we proposed in CP190.

- 2.4 Introducing the non-life ECR as a reporting tool reflects our recognition that it is a new requirement and that it is appropriate to allow a period of reporting so that we can assess its performance under different conditions. We also recognise that the non-life population is diverse and undertakes many different kinds of business that have different risk characteristics. The ECR as a standardised calculation can be calibrated appropriately for most non-life firms. However there may be a small minority of niche players amongst the non-life population for which the ECR as currently formulated is not adequately tailored to give an appropriate result. The ICAS framework will allow these firms to take better account of their individual circumstances.

Re-consulting on proposing the ECR as a binding capital requirement

- 2.5 We will review the performance of the non-life ECR taking account of our experience in implementing ICG and of market developments. We will also consider developments in the timing and substance of Solvency 2. Our current expectation is that a draft directive will be introduced to the Council and Parliament early in 2006 and a delay beyond this date is likely to cause us to reconsider introducing the ECR at that time. If so, we would intend to re-consult on the timing and calibration of the ECR.
- 2.6 The main changes we have made to the policy that was proposed in CP190 are:
- clarification of the exclusion of non-directive mutuals from the scope of application of the ECR;
 - better recognition of the effects of derivatives on the economic risk profile of a firm;
 - reduction to 0% of the risk weighting applied to investments in money market funds; and
 - removal of the requirement to report the result of the ECR calculation in the publicly disclosed annual return.
- 2.7 PSB text that reflects the changes that we have made may be found in Appendix 1.

3 Final policy on life ECR ('twin peaks')

- 3.1 This chapter gives an overview of final policy and any material changes from CP195 ECR proposals. More detailed feedback on the responses we received to specific questions asked on our ECR proposals in CP195 is set out in Annex 3.

Overview of final policy and changes from CP195

- 3.2 CP195 drew 39 responses, from parties including insurers and their trade associations, the Institute and Faculty of Actuaries, auditors and investment banks.
- 3.3 Almost without exception, the proposal of a realistic assessment of with-profits business has been viewed positively. The major points of debate were over the timetable for introduction, and the publishing and auditing of realistic figures; and related, over the scope of application of the realistic approach (the treatment of life non-profit business). Investment banks' analysis has focused on the likely effect of the realistic approach on life insurers' reported results and on the RCM credit risk test.
- 3.4 As noted in Chapter 1, we are confirming our CP195 proposals to assess required financial resources for with-profits business using a twin peaks approach. However, we have clarified and altered some of the technical detail of the twin peaks method, reflecting consultation responses and work conducted in the interim.
- 3.5 We have, for example, clarified that for twin-peaks firms provision for future reversionary annual bonuses may be excluded from the calculation of mathematical reserves, as these are addressed in the realistic peak. We have also concluded that any embedded value in non-profit subsidiaries and the present value of projected future transfers from with-profits subsidiaries of the with-profits fund may be recognised as realistic assets of the with-profits fund. Fifty percent of any embedded value in non-profit business in a separate

sub-fund of the long-term business fund will be permitted to count as capital to cover realistic capital requirements. To the extent that an embedded value asset arises from business within the with-profits fund, it must be subjected to the RCM stress scenario, excluding the persistency stress. For non-profit business outside the with-profits sub-fund and for subsidiaries of the with-profits fund, valuation for the realistic peak is net of the relevant capital requirement, and so assets arising from these sources are excluded from the RCM. These changes should help address respondents' concerns about inequity in the treatment of non-profit business within and without the with-profits fund. Finally, we've clarified that while subordinated debt of the with-profit fund must be treated as a realistic liability for the purposes of determining the assets required to cover realistic provisions, it is eligible as capital, at face value, to cover realistic, as well as EU, capital requirements.

The valuation rate of interest for realistic liabilities

- 3.6 The appropriate valuation rate of interest has been the subject of some discussion since the publication of CP195. A few firms suggested that using the swaps curve may be appropriate, especially as it is used by capital market participants to price derivatives. However, we consider that using the swaps curve unadjusted is unlikely to be appropriate. If a firm were to replicate the cash flows of a bond with a deposit and a swap, it would assume counterparty risks on interest and principal repayment relating to the deposit, and in relation to its bank swaps counterparty, and the swaps curve reflects compensation for this risk. This counterparty risk compensation accounts for much of the differential between the gilts and swaps rates.
- 3.7 For this reason, we tend towards the view that a valuation rate of interest based on the forward gilts curve would be more appropriate, and are mindful that the gilts rate reflects the return actually achieved on firms' gilts holdings. However, we do recognise that from time to time, certain gilts may be subject to pricing distortions if demand outstrips supply, and that it may be appropriate to adjust for these.
- 3.8 We are encouraged that the Institute and Faculty of Actuaries has commenced work of its own on the appropriate valuation interest rate, which considers the matter in more detail. We understand that this may result in a practice note to the profession on a similar timetable to PSB implementation. Therefore, for the time being, our PSB text continues to refer to the 'risk free yield' without being more specific. Before we 'make' our final text, we will review the framing of our rules and guidance to consider whether a reference to any actuarial practice note may be appropriately inserted, or whether to supplement them with guidance on the approach outlined above.

The RCM

- 3.9 We stated on publication of CP195 that we would conduct further actuarial work on the calibration of the RCM requirements that we proposed there. We engaged Watson Wyatt to conduct further testing on our CP195 proposals, and that work is now completed. Watson Wyatt's report to us, summarising their method and their findings, will shortly be published on our website¹¹.
- 3.10 There has also been intervening interest and comment from investment banks' analysts relating to the operation of the credit stress component of the RCM. This focused on:
- the likely asset mix that life firms would hold as a result;
 - whether it provides appropriate incentives for good risk management; and
 - how it compares to capital requirements for credit exposures of banks.
- We have taken that commentary into account in revising and finalising our RCM requirements.
- 3.11 Our revised RCM rules require firms to stress-test the same risk factors as we proposed in CP195, namely equity, interest-rate, real estate, credit or counterparty, and persistency risks. The actuarial work conducted confirmed that these are the most material risks an average with-profits firm. Generally speaking, though, it has been concluded that we calibrated the RCM a little too high in CP195 to achieve the confidence level desired. (That level was roughly the same amount of capital as would be required to reduce the probability of the market value of assets falling below the market value of liabilities during a one year period to a level consistent with a BBB (or equivalent) credit rating default probability¹².)
- 3.12 So, we have reduced the required stresses in the final rules, though this has not been a uniform reduction in each case. We have made changes such that:
- each risk factor stress in isolation now tests to a similar confidence level; and
 - when the results are aggregated we have achieved the desired overall confidence level (roughly a 99.5% confidence level that the firm concerned will continue to have assets to cover its liabilities over a one-year period).

11 Watson Wyatt LLP: *Calibration of Enhanced Capital Requirements for with-profits life insurers* (July 2004)

12 Standard and Poors definition of Insurer Financial Strength ratings: a BBB rated insurer 'has *good* financial security characteristics, but is more likely to be affected by adverse business conditions than are higher rated insurers'. There are a number of credit rating agencies providing similar services to the industry, of which Standard and Poors is one example. Our reference here should not be taken as implying that we express any preference or make any determination on the methods employed by any agency.

- 3.13 In addition, whereas CP195 proposed that firms should test the effects of a fall in equity prices, a fall in real estate values, and an increase in persistency rates, our amended rule has made these tests two-sided, such that firms' results must reflect the more adverse of a fall or a rise. (The interest-rate test in CP195 was already two-sided). Where it is clear to a firm which scenario will give the most adverse result, we will not require that detailed calculations of the results of other scenarios must be conducted. However, we will expect a firm to be able to demonstrate how it has satisfied itself that it has tested the effects of the most adverse scenario.
- 3.14 It should be noted that the actuarial analysis did not find evidence to support the RCM stress dampening mechanisms that were proposed in CP195, which had the effect of reducing the required stress tests after sharp market falls. With the exception of the equity stress, we have not retained any such mechanisms in our final policy.
- 3.15 For UK equities, firms will now be required to test the effect of a fall in market values of equities of at least 10%, or if higher, a fall of 20% less (100% minus the ratio of the current value of the FTSE actuaries all share index to its average value over the preceding 90 days). This dampener reduces the stress that a firm is required to test immediately following a sharp market fall. Where the fall is sustained, the required stress increases only gradually back to 20%, over the three months following the fall. This allows firms 90 days in which to consider whether any sharp equity market fall is simply short-term volatility requiring no action or whether they need to seek additional capital, to rebalance their asset portfolios, or to take management action to manage their liabilities. But the period is not so long as to permit inappropriate delay of important management decisions. The CP195 equity stress dampener that compared the earnings yield on the FTSE actuaries all share index to the long-term gilt yield has not been retained for the RCM.
- 3.16 The resilience test on mathematical reserves remains as it was proposed in CP195, and in line with current IPRU requirements. The retention of stress dampeners in this test reflects the fact that mathematical reserves are less responsive to changes in fund asset values than realistic provisions. In addition, we did not consider it appropriate to change capital requirements for non-profit business in the absence of robust realistic numbers as a basis on which to do so.
- 3.17 As we noted in Chapter 1, we have also revised the RCM credit stress test to take account of comments that we received on the CP195 proposals, and to reflect further work that we have conducted. We found that because the test was not sufficiently granular, the test could produce perverse results – more risky assets could attract a lesser credit risk capital requirement than less risky assets. In addition, the test did not perhaps take sufficient account of the duration of the credit exposure.

3.18 We have made three main changes to the credit test:

- we have excluded highly rated sovereign and central bank debt, supranational debt and debt of multilateral development banks from the credit risk test, on a basis similar to the Basel 0% credit capital requirements for banks;
- for other securities, insurers will now be required to test for each security held the effect of a widening of its current market credit spread. The required widening will be a multiple of the square root of the current spread, and no longer subject to a ceiling. The multiple required will vary according to the credit rating of the security. This recognises that when there is a general widening of credit spreads, the spreads of riskier credits widen the most; and
- we now require any derivatives to be subject to the credit test. This is to ensure that where a firm, for example, synthetically replicates the cashflows of a bond with a deposit and a derivative, this is adequately taken into account.

Market consistent valuation and financial accounting

3.19 Many life firms currently use mid-market prices, rather than bid and offer, to value their assets. Some respondents to CP195 therefore raised the question of the appropriate market consistent valuation of realistic liabilities in view of differing accounting treatment of assets. We recognise that symmetry of treatment of assets and liabilities is important. So, we have inserted some guidance into our PSB text on realistic liabilities to refer to the need for symmetry. In addition, a transitional provision to our valuation rules in PRU1.3 allows firms to continue to use mid-market value for their assets, for the time being, where they currently do so. But as financial accounting standards change, to require bid and offer valuation in firms' financial statements, firms' regulatory accounting should also move, in line. When valuation of assets changes, valuation of firms' liabilities should also change, to a value more reflective of hedging cost.

3.20 We expect that IAS39 will in practice require UK listed firms, and firms in UK listed groups, to move to bid and offer valuation for financial years commencing on, or after, 1 January 2005. So, UK listed firms may choose to continue with mid-market regulatory accounting for their regulatory return for the financial year ending 31 December 2004, but are likely to need to change from this basis for the financial year ending 31 December 2005. For other firms our proposed transitional provision would permit firms to continue to use mid-market value for two years following the coming into force of the PSB. We will consult on the transitional provision in our July 2004 quarterly CP.

4 Final policy on capital definition

Overview

- 4.1 CP190 and CP195 consulted life and non-life insurers separately on the same draft PSB text relating to the proposed definition of capital, as the same definition of capital will apply to both for meeting the MCR. The questions were also similar in both CPs (though differently numbered), with the exception of an additional question in CP195 relating to proposed guidance on implicit items. This chapter gives an overview of our final policy on definition of capital and summarises material changes from CP190 and CP195. Feedback on responses to specific question posed in those CPs is given in Annex 4.
- 4.2 Most respondents considered that the new rules on the calculation of capital resources were generally clear and that the changes made sense in the interests of consistency and harmonisation between sectors. Respondents also welcomed the opportunity to use innovative capital instruments to supplement their capital resources when meeting capital resources requirements above the minimum Directive requirements.
- 4.3 In broad terms our response to the feedback is to implement the rules as proposed in CP190 and CP195, focusing on components of capital, and dividing it into tiers. Even so, our amended PSB text does reflect some minor modifications of CP proposals. We have:
 - simplified some categories of capital, for example we have simplified terminology for innovative tier 1 instruments;
 - in response to feedback and to comply with directives, clarified the limit on lower tier 2 capital;
 - clarified the operation of the limit on innovative tier 1 together with other tier 1 limits;

- removed the condition that lower tier 2 capital documentation should provide for deferral of coupon and principal payments if a firm would be placed in breach of its capital resources requirement (CRR);
 - included new requirements for subordinated debt to be subordinated to fair provision for discretionary benefits to with-profits policyholders, consistent with treating customers fairly. Our July 2004 miscellaneous CP will consult on grandfathering and transitional arrangements for this; and
 - introduced a requirement for a QC opinion for perpetual subordinated debt and innovative tier 1 to confirm that it is loss absorbent on going concern basis.
- 4.4 We are confirming harmonisation of requirements for perpetual subordinated debt and perpetual securities.
- 4.5 Further detail on these changes may be found in our feedback on consultation responses we received, in Annex 4. PSB text reflecting these changes may be found in Appendix 1. We will consult in our July 2004 quarterly CP on carrying across to the PSB the current IPRU transitional provisions relating to increases in firms' Base Capital Resources Requirements and Minimum Guarantee Funds stemming from Solvency 1.

5 Final ICAS policy

- 5.1 In CP190 and CP195 non-life and life insurers were consulted separately on draft PSB text setting out our proposed rules and guidance for the ICAS framework. Under the ICAS framework a firm would be required to make an individual assessment of its capital needs (ICA). In addition, we also proposed to give most firms individual capital guidance (ICG) reflecting our own view of what adequate capital would be for their particular business. This PS confirms our intention to implement the ICAS rules and guidance, broadly as proposed in those CPs.
- 5.2 Responses to our CPs suggested that firms wanted greater clarity over how we intend to operate ICG, and what the implications of falling below the level of capital indicated by ICG might be. So, we have, in our amended rules and guidance (in Appendix 1), sought to make this clearer, and in our July CP we will consult on a proposal to introduce a notification requirement where a firm's capital falls below its ICG. In addition, some commented that capital is not the only, nor indeed in some circumstances the most appropriate, tool to address risks that a firm may pose to our regulatory objectives.
- 5.3 We consider that, as ICG gives our view of what an adequate level of capital is for a particular firm, it represents a regulatory intervention point. We envisage that, for intervention purposes, ICG will be set taking into consideration capital consistent with a 99.5% confidence level over a one year period or, if appropriate to the firm's business, a lower confidence level over a longer period. Firms should therefore prepare their ICAs on the same basis. Throughout whatever period is adopted, firms should ensure that their projected assets are sufficient to enable their projected liabilities to be paid as they fall due, and it may be appropriate for this to be tested at least at the end of each year of projection. We also recognise that firms may also wish to make estimates of their capital adequacy for their own internal purposes using other assumptions.

- 5.4 As a result firms are likely to want to maintain a capital buffer above the level of the ICG although the size of this buffer is at the discretion of an individual firm.
- 5.5 As part of the ICAS process, we would of course expect a firm to indicate if it does not accept any ICG we have given. Where a firm does not accept ICG, or proposes to ignore it, and if agreement through further analysis and discussion cannot be reached, then we will consider using the own initiative variation of permission process to impose a requirement on a firm's permission (under section 45 of FSMA). This will be the case both for ICG given for a firm's own capital adequacy and ICG given to a firm in respect of group capital.
- 5.6 Where agreement has been reached with a firm on ICG, we would expect – consistent with our Principle for Businesses 11 – a firm to inform us as soon as its capital falls or is expected to fall below its ICG. In such circumstances a firm will be asked to explain what has caused the situation and how it intends to improve its capital position, or how it considers that circumstances have changed such that the ICG is no longer appropriate. The range and severity of the steps we might then take could vary according to the circumstances but could extend to the same actions we would take where a firm is in breach of a threshold condition. We intend to consult in our July 2004 quarterly CP on draft guidance on this point, to be inserted into the Supervision Manual.
- 5.7 We agree that capital is not always the only, nor sometimes the most appropriate, tool to address identified risks. And we have also said that our ICA reviews will often be conducted at the same time as our Arrow risk reviews. We normally follow up any Arrow review with a letter to a firm, summarising our risk assessment and setting out the supervisory plan, which may include giving ICG. So, a firm may be asked to take other actions as well as holding capital consistent with any ICG we have given. For example, a firm may be asked to improve its ICA process, especially as we regard a firm's senior management as principally responsible for ensuring the capital adequacy of the firm. Or our ICG may incorporate specific 'add-ons' to a firm's ICA to reflect our assessment of a firm's management, or controls. Or a firm may be asked to take actions to de-risk part of its business. On occasion, we may combine capital guidance and actions – for example if additional capital would be appropriate to provide some risk mitigation while a firm's controls are being improved.
- 5.8 We are already talking to some firms about their ICA preparations, and we will take up this work in earnest in the third quarter of 2004. All firms are of course currently required to maintain adequate financial resources under FSA Principle for Businesses 4, but with effect from 1st January 2005 firms should be in a position to explain to us how they have assessed their ICAs. We will take into account the fact that internal processes and methods take time to evolve and implement, and we recognise that we may be looking at work in

progress for some time. We intend to review firms' ICAs over a two and a half year period, starting with those firms that are highest impact, or where the business or risk profile warrants early attention.

- 5.9 Further feedback on the responses received to the specific questions which we asked in CP190 and CP195 may be found in Annex 5. Our PSB text may be found in Appendix 1.

6 Summary of final directors' report, audit and actuary policy

- 6.1 PS167 confirmed that a life insurer's provisions for liabilities to policyholders in the annual return would be brought within the scope of the audit and that the auditor must appoint an independent reviewing actuary to advise him on their valuation. In addition, the valuation of liabilities would be brought within the scope of the directors' report on the annual return. The purpose of making these changes from the current Appointed Actuary regime was to clarify the responsibility of a firm's senior management for ensuring that proper provision for liabilities has been made, and to ensure that the valuation of liabilities, along with the other aspects of a firm's balance sheet, is subject to independent review.
- 6.2 CP202 proposed wording for the directors' report and the audit report. It also proposed that the independent reviewing actuary appointed by the auditor should offer a public personal opinion on the valuation of the liabilities, and proposed wording for that report.
- 6.3 CP195 proposed that for life insurers that have with-profits liabilities, the same concepts should be extended to the realistic peak as to the mathematical reserves and EU capital requirements. It therefore proposed to bring the realistic peak within the scope of the audit and reviewing actuary's and directors' reports, and proposed amendments to the wording of the reports to reflect this. It also developed the with-profits actuary report to policyholders on the firm's exercise of its discretion over with-profits business, which was set out in PS167, to extend that also to the realistic peak.
- 6.4 This policy statement sets out our final policy on all these proposals, with the exception of the report from the with-profits actuary, where we are still considering our position on whether it would be more appropriate for this to be addressed to the firm's directors, though still disclosed to policyholders. We intend that the requirement for a report from the with-profits actuary will be in respect of firms' financial years commencing on or after 1 January 2005,

and so the first reports will not be required before the end of 2005. As a consequence, we have some additional time to assess the consultation responses we have received and confirm our policy on this aspect of our requirements.

- 6.5 We received a number of comments on various aspects of the director, audit and reviewing actuary proposals in CP 195 and CP202. And in response to these we have changed some elements of our policy, recognising what we felt was a valid concern about potential lack of clarity over responsibilities.
- 6.6 Both the regulatory peak and realistic numbers will remain within the scope of the audit and the directors' report. But, in response to concerns raised by the auditing profession, we have decided not to require a separate public, personal opinion from the reviewing actuary appointed by the auditor. The auditing profession was concerned that the actuarial opinion and report scope were not aligned with the audit, and yet formed part of the overall report by the auditors. It was thought that this was an unworkable reporting framework and that users would be confused as to who was reporting on what, and who had ultimate liability for the audit opinion. It was also pointed out that the proposals would fail to comply with the audit profession's proposed Ethical Standards, and undermined the concept of a unified single audit opinion.
- 6.7 The Penrose Report (Ch 20, para 49) also recognised difficulties, commenting that new legislation would be required to achieve a joint opinion of the auditor and an independent actuary, for which they would be jointly and severally liable, which the report considered would perhaps be the ideal. Lord Penrose concluded that the most important point was to have a single opinion, covering the whole of a firm's balance sheet.
- 6.8 So, to address the technical problems we have encountered and to achieve a clear line of responsibility and liability for audit reporting, we have made some changes to our final requirements. These have clarified both the audit scope and the reporting framework for the reviewing actuary. Our Handbook text provides that:
- the auditor will still be required to appoint an independent actuary who will review the firm's actuarial investigation into the appropriate provisioning of its liabilities (and, so, its valuation reports);
 - but the reviewing actuary will now report directly and privately to the auditor, giving his or her view on the reasonableness of the valuation of liabilities by the firm, the methods used, and the economic, market and actuarial assumptions on which the calculations are based;
 - the audit report will make it clear that the scope of the audit encompasses a review of those aspects of the actuarial investigation that give rise to disclosures in the main reporting forms and the valuation reports, and the auditor will be fully liable for the audit opinion on relevant parts of the annual return, including the valuation reports;

- the audit report will explicitly state that the auditor has been advised by a suitably experienced and qualified actuary, and that all relevant associated professional guidelines have been complied with; and
 - the audit opinion will report on whether a firm's liability provisions, and valuation methods and assumptions disclosed in the valuation reports, have been properly prepared in accordance with our rules.
- 6.9 We are satisfied that these amendments will clarify the issue of professional liability, enable auditors and actuaries to work within the current legislative framework and their own professional guidelines, and provide the same level of audit assurance and independent actuarial review as proposed in CPs 195 and 202.
- 6.10 We note also that actuarial work carried out as part of the audit will, along with other aspects of audit work, be subject to potential review by the Audit Inspection Unit, operating under the umbrella of the Financial Reporting Council. Annual report users should be able to draw some comfort from this quality assurance control.
- 6.11 We are considering whether to convene a working group to assess the feasibility of overcoming the legal, professional and ethical issues that are currently a bar to joint opinions from auditors and actuaries. However, we recognise that progress towards joint opinions would require the involvement of a number of other parties such as the professions and the DTI, and that government would need to effect necessary legislative change.
- 6.12 Our PSB requirements, extending the scope of the audit to cover the whole of a firm's balance sheet, including provisions for liabilities, with the support of the reviewing actuary framework, are an undoubted improvement over the unclear division of responsibilities and potential lack of independent review of provisions for policyholder liabilities associated with the previous Appointed Actuary regime.
- 6.13 We have in our Handbook text also made some minor amendments to requirements for the Directors' report, to make it more consistent with our existing rule breach notification requirements in the Supervision Manual.
- 6.14 Handbook text reflecting these policy changes may be found in Appendix 1 (IPRU 9). In addition, we give more detailed feedback on the responses we received to CP195 and CP202 questions in Annex 6.

7 Final realistic reporting forms

- 7.1 In CP195, to support the ECR ('twin peaks') calculation for life insurers doing with-profits business, we proposed two new reporting forms which would form part of the annual reporting package. These were forms 18 and 19: a calculation of the WPICC, and the realistic balance sheet of the with-profits fund, respectively. In addition we proposed a new realistic valuation report, which would require a firm to disclose publicly the main methods and assumptions underlying its realistic valuation. This extended the concept of the valuation report that a firm is required to make summarising its actuarial investigation into the mathematical reserves required for with-profits and non-profit business in the regulatory peak.
- 7.2 This Policy Statement confirms that we will require these additional forms, and the realistic valuation report, in the public annual return. We will also require completion of the realistic reporting forms and reporting of material valuation method changes privately on a half-yearly basis. The forms and valuation report remain largely as proposed in CP195. Even so, some changes have been made to reflect the changes to the twin peaks calculation, which we have discussed in Chapter 3 and to make more transparent what other assets are potentially available within a firm. For example, they now reflect the additional types of assets brought in to the realistic peak, including embedded value of non-profit business outside the with-profits fund. Where additional embedded value or shareholders' funds are available in the firm, but not currently required to meet realistic requirements, these may now be separately disclosed at the foot of form 19. And an adjustment to include the face value of subordinated debt in capital available to cover the RCM.
- 7.3 We have modified our requirements for the realistic valuation report, in response to respondents' concerns about potentially unrepresentative disclosures required in CP195 for stochastically modelled guarantees, options and smoothing, and about lack of comparability between firms. We have replaced the proposed requirements for disclosure with a table requiring firms to disclose the risk-free rate assumed in their modelling and the values generated by their asset models

for a standard list of assets and options. In addition to helping us, we consider that this should provide useful information to firms and other users of the annual return as to how a firm's model compares to those of other firms.

- 7.4 These changes are reflected in the Handbook text in Appendix 1 to this Policy Statement. In addition, we give more detailed feedback on the responses we received to CP195 in Annex 7.

8 Revised cost benefit analysis for changes to life ECR

This chapter has CBA revisions for changes to CP195 ECR proposals. Feedback on responses to the CBA in CP195 and confirmation of the CBA in CP190 may be found in Annex 8.

Costs and benefits analysis for changes to CP195 ECR proposals

- 8.1 As part of this Policy Statement we are publishing amended rules and guidance for life insurance firms. We consider these final rules to differ significantly from the draft rules published in CP195 in two respects. So, Section 155(6)(b) and 157 of the Financial Services and Markets Act 2000 require us, in this instance, to publish details of these differences accompanied by a cost-benefit analysis (CBA).
- 8.2 This CBA deals only with areas where the final rules and guidance differ significantly from the draft in CP195. Where the rules are not changed in any way that we consider to be significant, the CBA in CP195 still stands. Therefore, this CBA should be read alongside Annex 3 of CP 195.
- 8.3 We discuss below the impact in terms of costs and benefits of changes to our initial proposals.

Treatment of non-profits business

- 8.4 The treatment of non-profit business has changed, as described in Chapter 3: for non-profit business outside the with-profits fund, 50% of the embedded value can be used to cover the WPICC:

Estimate of the costs: The effect of the proposal will be to reduce the capital requirements for firms that operate with-profits and non-profits business in separate funds, relative to the requirements in CP195. We do not believe the scale of the reduction will lead to a significant reduction in investor protection

for two reasons. First, we calculate that the reduction in capital requirements is small (approximately 10%). Second, the protections of the Pillar 2 ICAS requirements are not affected.

Analysis of benefits: In theory, a reduced capital requirement will lead to an increase in operational efficiency, which, in a competitive market, we expect to be reflected in lower prices being charged to customers (and an increased volume of business being transacted). However, in practice, we do not expect changes in capital requirements of the magnitude proposed here (see previous paragraph) to have a significant impact on these market outcomes. So we do not claim significant additional economic benefits from this policy change, relative to the benefits of the policy proposed in CP195.

We believe that the new treatment of non-profits business introduced in this policy statement does not change the CBA for CP195 in any other way other than described above.

Calibration of the RCM

8.5 As discussed in chapter 3, the revised RCM stress tests are:

- the more onerous of a rise or fall in the market value of equities of 20% (with the 90 day dampener only);
- the more onerous of a rise or fall in the market value of property of 12.5%;
- the more onerous of either a fall or a rise in yields on all fixed interest securities equal to a movement of 17.5% in the long-term gilt yield;
- an adverse change in future persistency experience of the more onerous of either a fall or a rise in termination rates, equal to a change of 32.5% in the rates assumed in the calculation of the realistic value of liabilities; and
- A revised credit test which excludes high quality sovereign, supranational and other credits on a basis similar to Basel requirements for banks, and which for credits falling outside the excluded list, requires a firm to test a widening of the current market credit spread. The required widening is a multiple (varying by credit rating) of the square root of the current spread.

Estimate of costs: Table 3.3 of Annex 3 to CP195 estimated the RCM for a sample of firms. The RCM has been recalculated as at December 2003 and our approximate estimate is that the change in the RCM stress factors will reduce the RCM by around 16%. Therefore, we believe that the combined effect of the revised RCM stress tests on firms' costs is broadly neutral.

Analysis of benefits: We believe that the changes proposed improve the RCM calibration for the reasons described in paragraphs 6, onwards, of chapter 3. The CBA in CP195 was based on the assumption that the calibration of the

RCM was accurate. So, the benefits that we now expect to flow from the revised calibration are the same as the benefits that we expected to flow from the calibration originally proposed in the CBA in CP195.

We judge that the new calibration of the RCM introduced in this policy statement does not change the CBA for CP195 in any other way other than described in this section.

Compatibility statement

- 8.6 In Annex 2 of CP195, we published the compatibility statement required under section 155(2)(c) and 157(3) of FSMA. We believe that the rules and guidance in Appendix 1 are still compatible with our general duties under section 2 of FSMA and the compatibility statement in CP195 continues to be appropriate. In particular, we would not have written the compatibility statement in CP195 differently if it had been based on the proposals now being implemented, rather than on the proposals that were subject to consultation.

Lists of non-confidential respondents to CP190 and to CP195

CP190

Association of British Insurers (ABI)
AVIVA
AXA UK Ltd
Aioi Insurance Co of Europe Ltd
Allianz Cornhill
Amlin Underwriting Ltd
Bar Mutual Indemnity Fund Ltd
Brit Insurance Ltd
Nottingham University Business School
Citibank Service Working Group
Combined Insurance
Congregational & General Insurance plc
DAS Legal Expenses Insurance Co
Danish Re
Deloitte & Touche LLP
Ernst & Young LLP
FSA Consumer Panel
FSA Business Practitioner Panel
General Reinsurance UK Ltd, General Star International Indemnity Ltd
& Faraday Reinsurance Co. Ltd
HealthSure Group Ltd
Hospital Savings Association (HSA)
Housing Associations Mutual Insurance Association

INVESCO Asset Management Ltd
Institute Faculty and Institute of Actuaries
Institutional Money Market Funds Association, (IMMFA)
International Group of P&I Clubs
International Transport Intermediaries Club
International Underwriting Association
KPMG LLP
Legal & General Group plc
Lloyd's Market Association
London General Insurance Co Ltd
Morley Fund Management Ltd
NFU Mutual Insurance Society Ltd
PricewaterhouseCoopers LLP
Pamia Ltd
Patients Aid Association
Pinnacle Insurance
QBE Insurance Group
RBS Insurance
Royal & Sun Alliance Insurance Group plc
Sabre Insurance Co Ltd
Solicitors Indemnity Mutual Insurance Association Ltd
St Paul Specialist Services Ltd
UK Defence Club
UK Mutual Steamship Assurance Association (Bermuda) Ltd
UK War Risks Association
Zurich Financial Services Ltd

CP195

Association of British Insurers
AMP UK
AXA Sun Life
Abbey National Group
American Life Insurance Company
Association of Friendly Societies
Aviva

B&W Deloitte
CIS
Canada Life
Combined Insurance Company of America
Ernst & Young
Friends Provident
FSA Small Business Practitioner Panel
The Institute of Chartered Accountants in England and Wales
Investment and Life Assurance Group
The Institutional Money Market Funds Association
Institute and Faculty of Actuaries
Investment Management Association
KPMG
Legal and General
Pricewaterhouse Coopers
Prudential
Royal London Mutual
Scottish Widows
Skandia
Standard Life
The National Farmers Union Mutual Insurance Society
Tillinghast
Virgin Money
Watson Wyatt
Zurich Financial Services

Feedback on responses to non-life ECR proposals in CP190

Q1: Is the ultimate scope of application for the ECR appropriate, or appropriate only with modifications to the ECR calculation?

1. In CP190 we proposed that the ECR should apply to all non-life insurers, including reinsurers and non-EEA firms with UK branches. However, we proposed to exclude non-directive mutual insurers and branches of Swiss general insurers before the date at which the ECR would become hard capital requirement, and firms in run-off were subject to a transitional provision.
2. The majority of respondents were comfortable with the proposed scope of application for the ECR. However, many highlighted the potential impact on international competitiveness of the intention to introduce these superequivalent proposals ahead of Solvency 2. A number of smaller firms were concerned that the proposed rules relating to the exclusion of non-directive mutual insurers from the scope of the ECR were unclear.

Our response: Having considered some respondents' concerns over the drafting of the proposed rules relating to non-directive mutual insurers, we have clarified the exclusion from the application of the ECR of all insurers that are not subject to the insurance directives. We will propose in our July 2004 quarterly Consultation Paper that non-directive friendly societies should remain subject to IPRU requirements for the time being. Other non-directive insurers will be subject to the PSB minimum capital requirement (MCR) only.

Q2: Are our proposals for derivatives appropriate and clear? If not please suggest alternative rules and guidance?

3. CP190 set out proposals for the ECR which would apply risk-weighted charge factors based on asset categories, claims and premium reserves. The ECR is capable of being calculated largely from information generated to meet our existing reporting requirements. However, the one exception to this was our proposal for additional information on derivative contracts.

4. The majority of respondents supported our proposal to take account of derivatives, with a number emphasising that firms should not be prevented from using derivatives for the purposes of good risk management. However, a few responses requested additional guidance on our proposals.

Our response: We have amended the calculation requirements for derivatives to place emphasis on the economic risk faced by a firm taking into account the combined effect of the derivative and associated assets. As a result, we hope that it is clear that we are not intending to introduce any disincentive to firms using derivatives for risk management purposes. In addition, as the ECR calculation is a reporting tool providing a benchmark against which to assess a firm's ICA, there is opportunity for firms to explain to us how they think the ICA calculation should vary from the ECR to reflect true economic risk.

Q3: Is it appropriate to adopt broadly the same definition of capital resources for meeting the ECR as for meeting the MCR (which will make aggregation of capital requirements for group purposes more practical)? If not, what approach would be more appropriate and why?

5. In CP190 we proposed to adopt broadly the same definition of capital resources for meeting the ECR as for meeting the MCR.
6. The majority of firms supported this proposal and felt that it would aid simplicity. However, some respondents qualified their comments with the proviso that the capital resources for the MCR may not always be appropriate for ECR purposes. This is because current EU Directives already adjust capital resources (through adjustments to net asset values) to reflect some of the risk measures the ECR is designed to capture.

Our response: We consider that the definition of capital resources used for meeting the capital resources requirement is the most appropriate definition to adopt when considering whether a firm has adequate capital to meet its ECR. Although we did receive some feedback on adjustments that could be made to the calculation of capital resources for the purposes of calculating the ECR, for example extending the range of admissible assets, we do not consider that many of these changes would be appropriate.

Q4: When do you think the ECR should be introduced as a prudential requirement?

7. In CP190 we explained that we would not initially introduce the ECR as a 'hard' capital requirement. However, we stated that we expected to be in a position in 2004 to indicate when this would happen.
8. The majority of respondents expressed serious concerns over our proposal to introduce the ECR as a capital requirement ahead of Solvency II. They argued that this would make the UK an uncompetitive market in which to write insurance business.

Our response: We have considered the views of respondents and have decided to introduce the ECR as a reporting tool, rather than as a 'hard', capital requirement. For the time being the ECR calculation will be reported privately to us. We will review this decision by 2006, taking particular account of what is known by then of the timing and substance of Solvency 2. Our current expectation is that a draft directive will be introduced to the Council and Parliament early in 2006. Any delay in this timetable is likely to cause us to reconsider introducing the ECR as a capital requirement.

Q5: Do you agree that introduction of more risk-based capital requirements (the ECR) is appropriate?

9. CP190 set out detailed proposals for a new risk-based minimum regulatory capital requirement – the ECR.
10. Most respondents were broadly supportive of the principle of risk based capital. However, their comments were tempered with the strongly felt view that the calibration of the ECR did not necessarily produce accurate risk profiles for individual firms and as such it would be inappropriate to use it as a 'hard' test (i.e. capital requirement) in the future.

Our response: As we have set out in our responses to earlier questions, we intend for the time being to employ the ECR as a benchmark against which firms' ICAs can be compared. In addition, we have changed the ECR asset weighting applied to investments in those money market funds that are either invested in cash or instruments demonstrating the same characteristics as cash to 0% from 16%. We also considered other changes to the calibration of the ECR but on balance decided that they were not appropriate. Additional details are given in the response to question 8.

Q6: Have we struck the right balance between practicality and sophistication? If not, should the ECR be more or less complicated?

11. With our CP190 proposals for the ECR we tried to strike a balance between ease of calculation (by basing it on the FSA returns) and precision.
12. The majority of respondents considered that a reasonable balance has been struck. Even so, many responses were qualified with a number of concerns. Most notable of these was the observation that as the regulatory return is produced only once a year, this implies that the ECR will remain fixed for the following 12 months.

Our response: We welcome the generally positive feedback to this question. The PSB (in PRU 1.2) introduces a requirement that a firm must maintain adequate financial resources on a continuous basis. A firm's capital requirement will therefore reflect its economic risk at any given point and will change over time to reflect the firm's changing circumstances. In addition, firms should note that we intend to express our ICG as a

percentage of their ECR. Consequently, firms will need to be in a position to monitor their ECR on an ongoing basis throughout the year to ensure that they continue to hold the appropriate regulatory capital.

See also our response to question 8.

Q7: Is there a better approach to deriving a risk-based capital requirement for liabilities that do not fall due for several years?

13. Many respondents acknowledged the inherent difficulty in attempting to produce a one-size-fits-all ECR framework. Some suggested that capital was not the best tool to manage long-term liabilities and called for greater emphasis to be placed on firms' management and their systems and controls. Other responses proposed alternate methods to address long term liabilities.

Our response: Many of the detailed concerns expressed in the feedback to this particular question related to the ECR as a 'hard' capital requirement. As, for the time being, we plan to implement the ECR as a reporting tool used as a benchmark in applying the ICAS framework, these issues diminish in importance.

Q8: Is our approach to calibration reasonable and does it achieve the degree of confidence in non-life insurers' ability to pay their liabilities that we seek? If not, should the capital requirement be higher or lower overall?

14. We explained in CP190 that we had calibrated the ECR to a 99.5% confidence level that a firm will survive for a one year period. We believe that this is consistent with a BBB rating for a large, well diversified insurer.
15. Many respondents were content that the chosen confidence level was indeed appropriate. However, some larger firms and groups suggested that although this confidence level might be consistent with observed BBB default rates, the amount of capital a group had to hold to achieve a BBB rating was less than the ECR calculation for this confidence level would imply. Also, a number of smaller firms were concerned that this approach to calibration would result in unnecessarily high capital requirements. Another respondent suggested that the ECR could be calibrated to smaller firms with the larger firms having the option to use the more sophisticated formula where they could justify a lower capital requirement.
16. A number of responses highlighted the potential impact of the proposed ECR capital charge on AAA rated money market funds and stated that it was excessive given the low risk characteristic of these funds.

Our response: Having weighed up the concerns of respondents we have decided to apply a 0% ECR capital charge to those money market funds held through collective investment schemes, which are either invested in cash or instruments demonstrating the same characteristics as cash.

In response to feedback we also considered whether a more granular approach to the ECR capital charges for reinsurance debtors was justified. But, we do not believe this is appropriate as firms are required under relevant professional guidance to establish general provisions proportionate to the credit risk profile of their reinsurance debtors. The ECR charge addresses the risk that there may be a deterioration in a firm's general provisions. However, we would expect firms to outline their methodology for calculating their general reinsurance provision as part of their ICA.

We have also decided to retain the calibration of the ECR at a 99.5% confidence level that a firm with this level of capital will maintain assets in excess of its liabilities for a one year period. We acknowledge that this may be more than the level of capital necessary to achieve a BBB credit rating where that rating reflects the ability of a firm to raise new capital from external or group sources. However, we still believe that this confidence level based on existing, rather than potential new capital resources is a useful benchmark.

Q9: Is our approach towards firms not meeting the ECR clear; should the regulatory responses be more graduated or prescriptive?

17. There were mixed responses to this question. While many respondents understood the proposed approach, many did not. A number of firms felt that CP190 did not make it sufficiently clear whether the ECR would be an annual calculation or whether it needed to be a rolling calculation, particularly in periods of rising premiums or claims. The bulk of the replies expressed concern over the proposed regulatory response to a breach of the ECR. They were particularly critical of the requirement to prepare a plan within 28 days in all instances of an ECR breach, regarding this as particularly cumbersome if the breach was a temporary dip due to normal volatility. Overall, it was felt that a more flexible, graduated regulatory response was desirable.

Our response: The question of the regulatory response to a breach of the ECR does not arise whilst the ECR is a 'soft' test, but it is relevant to expand on our regulatory response to a firm falling below its ICG. We have done this in Section 5 of this Policy statement.

Q10: Do you agree that the ECR should be included on public returns only after it becomes a prudential requirement, or is earlier disclosure more appropriate?

18. There was near unanimity in respondents desire not to see the ECR included on public returns before it becomes a 'hard' capital requirement.

Our response: As already set out in our response to question 4, we have decided to retain the ECR as a private reporting tool for the time being – a decision which we will review no later than 2006.

Whilst the ECR will not for the time being be disclosed in the public returns, we have written to firms asking them to complete a form setting out their ECR. We will be asking firms to submit this form privately at the same time as their annual returns as well as providing the information as part of any ICA review.

Feedback on responses to life ECR ('Twin peaks') proposals in CP195

Q1: Is this scope of application for the twin peaks approach appropriate? If it is not appropriate, what changes should be made?

1. Overall, respondents recognised that the 'realistic' basis encourages better risk management than the 'regulatory' basis because liability provisioning rules and capital requirements are both more responsive to risk mitigation strategies. The feedback strongly supported our proposal that firms with with-profits liabilities of less than £500million should not be required to adopt a 'realistic' approach.
2. A number of respondents commented that firms should have the option to report their non profit business, whether written within or outside a with-profit fund, on a realistic basis. Some respondents felt that the approach to non-profit business in with-profits funds was complex. One suggestion was that this business should also be valued on a realistic basis and subject to a stress test in the Risk Capital Margin (RCM) calculations. Some responses suggested that firms' subsidiaries should be valued on a realistic basis.

Our response: Our reforms in CP195 were addressed essentially at with-profits funds. This is because, as we have discussed in Chapter 1, it was with-profits requirements that were most in need of reform. In addition, it would not have been possible to extend the realistic approach to non-profit business in time to implement with-profits reforms in 2004. We also said in Chapter 1 that we will review whether to extend a realistic approach to non-profit business in the light of Solvency 2 developments.

We have outlined in Chapter 3, changes and clarifications we have made to our rules in relation to the recognition of embedded value of non-profit business as a realistic asset. Whilst a direct application of realistic methods to non-profit business might have been conceptually neater, we have not introduced this at this stage because of the systems implications for firms, and because a robust realistic method has not yet been developed.

Q2: Is the structure of capital requirements clear enough?
If not, which aspects require additional explanation?

3. Most responses stated that the structure of the capital requirements was clear, although some felt that the rules were rather complex. One respondent asked whether the WPICC could be restated in simpler terms. Other responses asked about the extent to which the WPICC could be covered by resources outside of the with-profits fund, in particular the value of non-profit business written outside the fund. Another response suggested that for realistic reporters reporting just the realistic peak and RCM should suffice.

Our response: Showing the WPICC as a separate incremental capital requirement in addition to mathematical reserves, the long-term insurance capital requirement (LTICR) and resilience test demonstrates clearly that a firm's aggregated with-profits and non-profit results meet the capital requirements of the Life Assurance Directive, which is implemented through the 'regulatory' calculation. The WPICC is then any extra that is required to bring a firm's with-profits results to a realistic basis. We consider that the WPICC is an appropriate measure that will become better understood as it is used.

As we have discussed in Chapter 3, we have amended the rules to allow 50% of the embedded value of non-profit business in a separate sub-fund of the long-term business fund as a deduction from the RCM.

Q3: Are the changes to the twin peaks approach appropriate?
If they are not, what modifications should be made?

4. Almost all firms agreed that the changes were generally appropriate. However, some firms argued that the MCR should be based on the higher of the LTICR (EU Directive solvency margin) and the Resilience Capital Requirement as resilience capital might be unnecessary for demonstrating compliance with EU minima. There were also comments that a resilience test which is close to, but not identical with, the RCM definition could be confusing.
- Other specific points raised on the resilience capital stress test were:
 - whether there should be a stress test on exchange rates;
 - whether a longer averaging period than 90 days would be appropriate for equity falls;
 - whether the proposed equity stress is too sensitive to changes in gilt yields;
 - whether the stress test applying to real estate was too strong in relation to historic volatility of the property index; and
 - whether a stress test for index linked gilts could be specified.

Our response: We consider it appropriate to retain both the LTICR and resilience capital requirements in the absence of robust realistic numbers supporting a reduction in the overall level of capital supporting non-profit business.

The resilience capital stress test remains unchanged from that we proposed in CP195. As resilience capital is a Pillar 1 test we have sought only to address the major risks for the majority of firms and so have not specified tests for the smaller asset classes. If the risks in an individual firm's actual asset holdings are not fully addressed by the resilience test, the other risks should be materially addressed when the firm undertakes its ICA. We do not consider it appropriate to lengthen the 90-day smoothing period for the equity stress as this might encourage firms to delay taking important decisions.

Q4: Is the modified twin peaks approach clear? If not, which aspects require more explanation?

5. Most respondents believed the approach was generally clear to them, although a number questioned whether it would be clear to people outside the industry. One response stated that for funds that contain both with-profits and non-profit business, the LTICR and resilience capital requirement are calculated in aggregate and cannot readily be split into with-profits and non-profit components.

Our response: We have been working with the industry to improve wider understanding of the twin peaks approach and expect to continue with similar activities as the methodology is implemented. We have given further guidance in PRU7.4 (Appendix 1) on the allocation of the resilience capital requirement to with-profits business.

Q5: Are our rules and guidance on realistic reserving sufficiently clear? Are there any areas that require additional clarification?

6. Again most respondents believed the rules and guidance are clear. However, there were some particular points raised:
 - Could the range of assets given value in the realistic peak be extended? In particular, could derivatives not held for the purposes of efficient portfolio management be included?
 - Could guidance be given on the risk-free rate to be used in valuing realistic liabilities?
 - Could further guidance be given on the assumptions for calculating the present value of future profits on any non-profit insurance contracts? Some respondents felt that the proposals left some subjectivity in the calculation.

- Could further guidance be given on how allowance for taxation should be made in the realistic calculations?
- Could the treatment of shareholder transfers be clarified?

Our response: Our response to Q1 sets out the changes we have made to the treatment of non-profit business. We consider that assets outside the with-profits fund, excepting the specific extensions in respect of embedded value, should not generally be permitted to count as assets backing with-profits liabilities except where a firm has been granted a rule modification under S148 FSMA. We consider that this is an appropriate control to ensure that those assets may be called upon when needed. The rules now permit all derivatives to be valued at market value in the realistic peak. This includes derivatives that are inadmissible under the regulatory peak. So, they will also be subject to the RCM stress scenario.

We have commented in the overview of final policy in Chapter 3 on the risk-free yields to be assumed in the valuation of liabilities.

We recognise that some firms would appreciate further guidance on the methods used to calculate the embedded value of non-profits business. However, the industry has invested much time in recent years producing the ABI guidance on Achieved Profits. In addition, the actuarial profession has recently been developing further guidance in this area. As a result, we do not consider it necessary to incorporate further guidance into our PSB text.

On tax, we have clarified our PSB text so that tax must be allowed for on a realistic basis on all the assets supporting the realistic liabilities and the RCM.

We consider that the value of future shareholder transfers out of the with-profits fund should be provided as a liability within the realistic balance sheet. Exceptionally, where a firm has put in place undertakings that these transfers will not be paid out of the firm by way of dividend, we may be prepared to grant a waiver from the rule.

Q6: Have we set out a practical approach to market consistent valuations, or should more prescriptive guidance be given?

7. Several respondents agreed that disclosure of the main assumptions underlying the modelling was more appropriate than being prescriptive about detailed model requirements. The following points were also raised in different responses:

- there is a need to achieve early consistency between companies, but equally there is a need to ensure that a prematurely prescriptive approach does not inhibit development of the best approach;
- some felt that market consistency would be difficult to achieve in some situations where markets are small or illiquid and the diversity of allowable models could make comparisons difficult;

- there is some scope for subjectivity in the choice of model and assumptions; and
- two respondents asked for further guidance on the requirements of a market consistent asset model.

Our response: We consider that disclosure of methods and assumptions is the best way to move towards consistency between firms over time. We recognise that firms need some additional guidance on market-consistent models and have given this in PRU 7.4. Our main criterion remains the ability of a model to reproduce current market prices of suitable assets to match a firm's liabilities. We have decided to require disclosure in the FSA Return of the valuation of specimen assets arising from firms' models (see also the feedback to Q20). This will provide a benchmark for the approaches adopted by different firms. The actuarial profession is also developing more detailed guidance on the use of stochastic modelling for realistic reporting.

Q7: Does a standard of market consistent valuation of options and guarantees represent good practice and a standard that firms can reasonably hope to attain?

8. Almost all respondents said that market consistency is the right goal for valuation of options and guarantees and that disclosure of methods and assumptions is the right approach at this stage ahead of greater convergence in practice. However, many respondents felt that an accurate market-consistent valuation might not be achievable where a deep and liquid market does not exist for matching instruments. Market consistent pricing could therefore only be achieved by proxy. Differences in the resulting assumptions could lead to non-comparable results.

Our response: We recognise that there are difficulties in defining a market-consistent approach where there is no deep and liquid market. We have extended our guidance on market-consistency and the actuarial profession is also developing more detailed guidance in this area.

Q8: Is it appropriate to link our reserving requirements to firms' PPFM statements? If not, what would be more appropriate?

9. All respondents agreed that it is appropriate to link our reserving requirements to firms' PPFM statements. One respondent pointed out that a PPFM is only required for UK business. Another respondent asked for guidance on the circumstances under which planned changes to a firm's PPFM can be factored into the realistic balance sheet.

Our response: For non-UK business we recognise that a PPFM statement may not be published. We have given new guidance that in these circumstances firms should base their assumptions on the internally documented approach to the financial management of the non-UK business. Where changes to the PPFM are proposed, these should not be incorporated into realistic balance sheet models until the changes have been agreed by the Board and have been published.

Q9: Is it appropriate to adopt broadly the same definition of capital for meeting the WPICC as for meeting EC Directive capital requirements? This would make aggregation of capital requirements for group purposes more practical, but if the definition is not appropriate, what modifications should be made?

10. All respondents agreed that it was appropriate to adopt the same definition of capital. One comment suggested that inadmissible assets, other than those in excess of limits should be added back (see our response to Q5). Another respondent suggested the inclusion of future profits on non-profit business as capital available to meet the capital requirements (see our response to Q2).

Q10: Are our requirements on the amount of capital that must be maintained in the with-profits fund clear? Are these proposals appropriate? If not, what modifications should be made?

11. Most respondents stated that the requirements were clear. However, some felt that the value of non-profit business written outside the with-profits fund should count towards the capital requirements. (See our response to Q2.) Similarly, one response referred to the non realistic valuation of subsidiaries (again, see our response to Q1).

Q11: Are the changes we propose to mathematical reserves appropriate and are we right to introduce them now? If not, what would be more appropriate?

12. Almost all responses welcomed the proposals. Some respondents asked whether the changes to the reinvestment rate and persistency assumptions could be extended to cover non-profit and unit-linked business and whether the swap curve could be used as the basis for reinvestment assumptions rather than the gilts curve. Other responses were looking to retain flexibility in the approach to setting these assumptions. Several responses commented that the draft text was not clear for regulatory only firms regarding discretionary bonuses, and commented on the inconsistency between CP and draft PSB text regarding the treatment of annual reversionary bonuses by realistic reporters.

Our response: In CP195 we did not extend the changes to the rules on reinvestment rates and persistency to non-profit business as this could have resulted in a significant weakening of the capital requirements for non-profit business, without the benefit of robust realistic numbers as a basis for this. See Chapter 1 regarding our plans to review the extension of a realistic approach to non-profit business. With regard to the use of the forward gilts curve to determine the reinvestment rate, this represents the minimum basis on which firms can calculate liabilities. Firms do have the flexibility to adopt other methods provided the assumptions used are not weaker than those derived from the forward gilts curve. For regulatory basis only firms, we have retained the net premium rule for mathematical reserves for conventional with-profits business, and these firms should therefore include some provision for discretionary bonuses. For twin peaks firms, discretionary benefits are explicitly addressed in the realistic peak, and therefore we have clarified our PSB text to exclude provision for future annual bonuses from mathematical reserves.

Q12: Is our proposed design for the RCM appropriate? If not, what would be more appropriate? Are there any aspects that require clarification?

13. There were three main comments:
 - some respondents suggested that the persistency test should not be applied within Pillar 1 as it was likely to result in significant variations for different firms;
 - respondents also questioned the appropriateness of the credit risk stresses, which could give firms an incentive to invest in lower quality bonds; and
 - some said that the credit risk test was rather complex.
14. One reply suggested there should be specific stress tests for annuitant longevity and implied volatility on the market-consistent value of guarantees as well as other risks in the business. Another response suggested that the persistency stress test should refer to an increase or decrease in termination rates. Two respondents suggested that the stress tests do not allow for any diversification benefits.
15. Under the market risk stress test, it was commented that the 90-day smoothing period for equities might be too short and limit on the equity fall too sensitive to gilt yields. One response stated that the dampeners are not compatible with efficient markets because they imply a mean reversion.

Our response: We have established the stress tests for the RCM based on the principal risks for a typical with-profits fund. The work we commissioned from Watson Wyatt confirmed that the RCM stresses proposed in CP195 addressed the key risks for an average with-profits fund. So, we have retained the elements of the RCM we proposed in CP195, but have commented in chapter 1 and chapter 3 on changes to the calibration. Firms exposed to material risks that are not addressed by the RCM should address these as part of their ICA.

See chapter 3 for comments on changes to the credit risk test also. The revised credit test remains more complex than that currently required from with-profits firms, but we consider this appropriate for what is currently, and increasingly, an important risk factor for with-profits funds. As regards the persistency test, we have amended this to refer to either an increase or decrease in rates, depending on which gives the most adverse result, but have excluded embedded value of non-profit business within the with-profit fund from the scope of this test.

The calibration work carried out for us took into consideration a full range of risks to which with-profits funds are exposed, including operational risks. The assumptions also allowed for correlation between the various risk factors. The calibration of the RCM has therefore taken into consideration diversification effects between the risk factors.

As we also state in chapter 3, the gilt yield dampener on the equity stress has not been retained for the RCM.

Q13: What is an appropriate confidence level and period?

16. One response pointed out that the probability of failure approach is different to a credit rating benchmark because any rating implies a reduction in survival prospects over time on a non-linear basis. A number of respondents stated that a 0.5% chance of insolvency over one year might achieve a rating other than BBB due to the other qualitative factors that influence a credit rating. However, other respondents stated that they had reservations about expressing the framework in terms of a confidence level. High confidence levels imply rare events and calibrating these is an inexact science.

Our response: We recognise that a specified risk of failure is probably a better benchmark than a credit rating due to the factors other than capitalisation that enter the rating assessment. So, we have carried out our calibration work based on a 0.5% probability of failure over one year. We consider this a suitable benchmark for determining capital requirements as, for supervisory purposes, we are concerned to make sure that the probability of a firm failing, over the fairly short period of one year, is small. The assumed probability of failure is consistent with that applied to the capital requirements for general insurers and similar to that applied to other financial institutions.

Q14: Is our approach to enforcement of ECR clear?

17. Almost all respondents agreed that the approach was clear. However, one response asked what an 'adequate period' for a firm to submit a plan for restoring its solvency levels would be. This reply also suggested that firms should only be required to notify us if, for example, the ECR fell below 90% or had not met the ECR for 60 days.

Our response: We do not consider that failure to meet the ECR is any less significant than failure to meet the MCR. In the event that a firm failed to meet its ECR it should submit a plan to restore its capital position on the same timetable as would apply to breaches of the MCR. But, a full scheme of operations will not be required. We expect to consult on proposed rules and guidance for inclusion in the supervision manual in our July CP.

Feedback on responses to definition of capital proposals in CP190 & CP195

Q11 in CP190, Question 22 in CP195: Is this new approach to the calculation of capital resources for insurers clear? If not, which aspects need further clarification?

1. CP190 and CP195 changed from the IPRU net assets approach and proposed that capital resources should be calculated by adding the various components of capital such as share capital, retained earnings and subordinated debt. Furthermore, the components of capital were divided into classes or tiers of capital that reflected the permanence and loss absorption capability of the capital item. Those components of capital, such as ordinary shares, which provided the maximum protection against losses for the firm and its consumers, could be included in capital resources without limit. However, lower tiers of capital, could be included within capital resources subject to limits. The purpose of the various limits is both to comply with minimum Directive requirements but also to ensure that a firm's capital resources are of sufficient quality to meet the risks represented by its capital resources requirements. In addition, changing to a components-of-capital approach introduces a greater degree of harmonisation between insurers, banks and investment firms, and helps to provide a more consistent definition of capital when implementing group capital requirements.
2. Most respondents considered the proposed approach clear, although a number had specific comments on the details. Two smaller non-life insurance firms were of the view that the new approach to the calculation was generally complex and unclear and required further clarification.

Our response: By dividing capital resources into tiers and sub-tiers, we are better able to distinguish between the various components of capital and their ability to protect the firm against losses and to enable it to continue as a going concern. The complexity of the proposals simply reflects the range of capital instruments available to a firm. Investors and rating agencies are acutely aware of the different features of the instruments and they are priced accordingly. In general, a higher tier instrument

will be more expensive for the firm than a lower tier item. The tiering approach is already familiar to banks and investment firms and it is only likely to be the larger and more sophisticated insurers that would raise capital using various instruments falling in to a number of different categories. Smaller firms with simpler capital bases are unlikely to be materially affected by the perceived complexity of the rules.

Even so, in response to feedback we have simplified some of the categories of capital. For example, we have deleted references to 'non-ordinary shares' which for insurers was the same as perpetual non-cumulative preference shares, and have simplified terminology for innovative tier one instruments. Finally, we have deleted the term 'hybrid capital instrument' and replaced it with the term 'tier two capital instrument', which should be a more transparent term.

Also, in response to feedback and in order to comply with the relevant Directive on lower tier two capital (most commonly in the form of dated subordinated debt) we have added a new limit that requires at least 75% of a firm's MCR to be accounted for by tier one and upper tier two capital items.

We appreciate that some firms wish to see revised regulatory reporting forms in order to fully understand the new approach to capital resources. So, we will be consulting on new reporting forms in our July 2004 'quarterly' CP.

We also received feedback that the 50% limit on non-cumulative preference shares within tier one capital was more restrictive than required by the relevant Directive. The 50% limit reflects our belief that preference shares do not provide the same protection and flexibility to a firm as ordinary shares and retained earnings, and that full discretion over dividend payments is an important distinction between shares and lower classes of capital. There is less scope to vary the coupon on preference shares and investors typically regard preference shares as more akin to debt instruments than equity. Furthermore, existing preference shares often have features such as call dates and limited discretion on coupon payments that make them more similar to debt instruments.

Under the new rules, unless the terms of preference shares allow the issuer full discretion about whether or not to pay a coupon, even when the firm is not in breach of its capital requirements, then the preference share will not be eligible for inclusion in tier one as perpetual non-cumulative preference shares. We consider that this limit is unlikely to have a material impact on a firm's capital costs because:

- insurers have not historically sought to raise significant amounts of preference share capital in the external market to meet their capital requirements;
- firms can raise innovative tier 1 and tier 2 capital; and
- ratings agencies also consider leverage when rating firms' capital instruments

We have relaxed the CP190 and CP195 proposals that deductions for inadmissible assets (apart from goodwill and other intangible assets) and for assets in excess of

market and counterparty limits should be made from tier 1 capital. We have subsequently decided that it would be more appropriate if these deductions were made from total capital. The reason for the change is that we recognise that these assets are likely to have some value when the firm is in financial stress whereas other deductions from tier one capital may have no value. This has the effect of increasing the potential amount of tier two that a firm can raise, as that is limited by reference to tier 1 capital.

Question 12 in CP190, Question 23 in CP195: Are the rules on capital instruments and innovative Tier 1 sufficiently clear and, if not, what changes should be made?

3. In CP190 and CP195 we proposed that firms could supplement their tier one capital with innovative tier 1 capital in order to meet any capital requirements above the minimum Directive requirements. Innovative tier one capital is already used by banks and we are introducing the same treatment for insurers.
4. Although respondents thought that the rules were reasonably clear, a number of respondents had detailed questions on the table set out in pages 33-34 of CP190 (page 62 of CP195). Several respondents provided helpful suggestions to make the rules clearer. These have largely been incorporated.

Our response: Clarification was sought on whether the 15% limit on innovative tier one capital within total tier one capital was a sub-limit of the 50% limit on perpetual non-cumulative preference shares. We confirm that the 15% limit is a sub-limit of the 50% limit. Put another way, a firm cannot count as part of its tier one capital resources both 15% of innovative tier one capital and 50% of perpetual non-cumulative preference shares. The purpose of these restrictions is that at least half of a firm's tier one capital comprises items where there is no doubt about their permanence or loss absorption capability. Any surplus preference share or innovative tier one capital can still be used to meet a firm's capital requirements but would be added to tier two capital components and subject to the various tier two limits.

We have also included new rules whose aim is to establish whether a tier one innovative instrument is sufficiently loss absorbent on a going concern basis to be counted as tier one capital.

In order to preserve the characteristics of tier one capital, we have added a new condition that there should be no connected transactions that may reduce a capital item's ability to satisfy these criteria. A connected transaction might for example, include a guarantee or any other side agreement provided to the holder of the capital instrument and which may counteract the subordination provisions of the original instrument. Another example of a connected transaction might be a parallel transaction designed, for example, to achieve a tax benefit but which may compromise the loss absorption capability or permanence of the original capital instrument.

Question 13 in CP190, Question 24 in CP195: Do you agree that while innovative instruments share some of the characteristics of the components of Tier 1 capital, they are not equivalent to ordinary shares or reserves and their eligibility should therefore be restricted?

5. In CP190 and CP195 we set our views that certain types of capital instruments that have been developed in recent years have the characteristics of permanence and loss absorbency required for Tier 1 recognition. However, we consider that the inclusion of such instruments in Tier 1 should be subject to limits. While we believe that such instruments may be equivalent to preference share capital in economic terms, we do not consider that such innovative instruments are equivalent to ordinary share capital or reserves.
6. With some caveats, respondents agreed with the assertion in the question.

Our response: Following the supportive feedback to our proposals we are not intending to change the 15% limit on innovative tier one capital within a firm's overall tier 1 capital resources.

One respondent expressed concern that the rules would limit any potential new types of capital instrument to being accounted for as innovative tier 1, and subject to the associated limit. In response to this comment, the rules are not intended to exclude the possibility of a capital instrument, other than a share, counting as tier one outside of the 15% innovative tier one limit. However, we have not yet seen an instrument, other than a share, which fully meets the criteria required for non-innovative tier one. The main stumbling block has been certainty that any such instrument would be fully available to absorb losses to allow an insurer to continue trading.

Question 14 in CP190, Question 25 in CP 195: Should the treatment of subordinated debt and perpetual securities be harmonised, and if so, with what contractual provisions to satisfy directive requirements?

7. In CP190 and CP195 we proposed that the same rules should apply to all upper tier two capital instruments, even though EU insurance directives draw a distinction between perpetual securities and perpetual subordinated debt. Other than applying the minimum requirements laid down in the Directives, we can see no good reason why the requirements for all upper tier two instruments should not be the same, especially as both types of instrument are given the same amount of credit in the calculation of a firm's capital resources. The majority of those respondents expressing a view favoured harmonisation, though some respondents were concerned that the new rules may put UK firms at a disadvantage compared to their European counterparts.

Our response: We estimate that the cost of requiring undated subordinated debt to be loss absorbent on a going concern may be between zero and 35 basis points. The benefit of this change is to preserve the integrity of upper two capital which, in line with our requirements for other types of firm, should be loss absorbent on a going concern basis. In order to demonstrate that an upper tier two instrument (apart from a cumulative perpetual preference share) is capable of absorbing losses on a going concern basis, we will require firms to obtain a Queen's Counsel opinion to this effect. We will also require a QC opinion on loss absorbency for innovative tier one capital instruments. This is a policy already adopted for banks and we believe represents a very small proportion of the overall costs incurred in raising this type of capital. We understand that the costs of our requirement for a QC's opinion will be in the order of £2,000 to £5,000 per issue. A firm may not need to commission a new QC opinion each time it raises new upper tier two or innovative tier one capital. Where a firm can demonstrate that the terms of the capital instrument are materially the same as a previous issue as regards loss absorbency features and that there have been no changes in the relevant insolvency law, then we intend that the firm would be able to rely upon an opinion covering the previous issue.

In contrast, in response to feedback, there are other aspects of our requirements for tier two capital that we are easing. In CP190 and CP195 we proposed that a condition of all tier two capital (whether upper or lower tier two) was that coupons or principal payments should not be made if a firm was in breach of its capital resources requirement, or would be in breach following payment. Some respondents argued, particularly for lower tier two, that this was a stricter requirement than for banks and would add to the cost of raising lower tier two capital. This was probably the single most important objection to the proposals. For a lower tier two instrument, we have removed the general requirement to defer any amounts payable. For upper tier two, we have decided that a firm must have the option whether or not to pay a coupon if it is in breach of its capital requirements. Because an upper two instrument would always be perpetual, the principal amount should never fall due. The firm need not have the option to defer at a time when the firm is not, or would not be, in breach of its capital requirements. In the event that a firm's capital resources were below its requirements, we would expect that firm to discuss with us at the earliest opportunity its plans to restore its capital resources to acceptable levels.

We have also included new rules on subordinated debt of with-profits life insurance companies. Where the subordinated debt is a liability of the with-profits fund, repayment must be subordinated not only to the contractual entitlements of policyholders, but also to the fair provision for discretionary benefits. This requirement is consistent with our policy of treating customers fairly which was the main thrust for the reforms introduced in CP195 and transparent disclosure in a firm's PPFM introduced in CP167 and expanded in CP 207.

Question 26 in CP195: Is our guidance on implicit items clear and appropriate?

8. Most respondents agreed that the guidance was clear and appropriate. However, a number of detailed points were raised:

- that the application of the restriction of future profits to those emerging before the end of 2009 should be clarified in respect of waivers in force prior to PRU 2.2 coming into effect;
- clarification should be provided as to the meaning of the risk free rate and that equating it to the gilt rate is harsher than the standard for the realistic balance sheet;
- that the guidance presumably only applied to the regulatory peak and should be expanded upon to clarify the impact of the realistic peak;
- the guidance should cover the treatment of applications for waivers in respect of the non-profit fund only;
- the requirement to demonstrate that the financial position of the firm is resilient to changes in financial conditions should be clarified; and
- the management of capital may be somewhat difficult given the interaction of general capital tiering limitations and Solvency 1 requirements.

9. In addition, it was commented that:

- the Solvency 1 provisions phasing out implicit items heighten the need for progress in the UK and EU on Solvency 2 and a move to a realistic approach to capital for all life business. Without reform of Directive requirements, excess capital would in some cases be required for non-profit business;
- restrictions on the extent to which implicit items may be used to cover the CRR were generally at a reasonable level; and
- the restriction on future profits taken into account to those emerging before the end of 2009 may be problematic for some closed funds.

Our response: We are encouraged by the support expressed by respondents. Existing implicit items waivers remain unaffected by the 2009 limitation on the period for emerging future profits once PRU 2.2 comes into effect, until the date of expiry. If, at that date, a firm wishes to apply for renewal of its waiver, this will be treated as a new waiver application (for this purpose) and the PRU 2.2 provisions will come into effect. We note the comment about closed funds and will review any such cases in the light of their specifics. Other requests for clarification have been addressed by minor revisions of the guidance text.

Feedback on responses to ICAS proposals in CP190 & CP195

Question 15 in CP190 and CP195: Is the scope of application for the ICAS regime appropriate, or appropriate only with modification?

1. The ICAS proposals covered in CP190 and CP195 would be applicable to life and non-life insurers, including reinsurers but excluding Lloyd's. The proposed scope was the same as for the ECR, except that it also included non-directive mutuals and insurers in run-off.
2. Respondents were overwhelming supportive of the scope of application for ICAS although some questioned the application of the regime to those firms in run-off.
3. One respondent suggested that additional capital requirements could be a blunt regulatory tool if used to address systems and control weakness. They argued that this may not tackle the underlying issues and could conflict with our statutory objective to secure appropriate protection for consumers. Others commented that the approach should be proportionate to the risk profile of a firm. It was also thought appropriate that the framework should apply to other categories of firms. There was a request for further information on how the framework will be applied to bancassurers and composite companies. Some mention was made of the potential complexity and cost of implementation.

Our response: We have not altered the scope of the ICAS regime that we set out originally in CP190 and CP195. CP04/7 sets out how a similar regime will be applied to Lloyd's of London.

We have considered our existing proposals for firms in run-off. Although we do not intend to change the requirement for run-off firms to carry out regular assessments of their capital needs (the ICA), we have clarified how these firms should interpret this rule. We have added guidance in PRU 1.2 (and PRU 2.3, if appropriate – need to confirm) that confirms that whilst firms in run off may have relatively complex and sizable underwriting books, we would not necessarily expect the scope of their ICA assessments to be the same as comparable firms that are writing new business.

However, where a firm in run-off is proposing to withdraw capital or pay a dividend, a more thorough ICA would be appropriate.

We do intend to implement ICAS on a proportionate basis. We agree that in some circumstances a requirement for additional capital could be a blunt tool. We have already commented in Chapter 5 on how ICG fits with the Arrow risk assessment for a firm, and the wider supervisory plan.

We have indicated already in CP136 our intention to introduce an ICAS framework more widely, including for banks and investment firms. Our approach for firms that are members of groups is covered under our response to CP195 Question 19 below. We believe that, in line with the cost benefit analyses set out in CP190 and CP195, the cost and potential complexity are not excessive.

Question 16 in CP190, Question 18 in CP195: Is PRU 2.4 helpful guidance? Is there too much or too little detail? Do you consider stress and scenario tests should be more prescriptive and quantified?

4. To help firms understand how we expect them to approach the assessments required for capital purposes, we proposed to introduce a new section to the PSB. In the CPs this was PRU 2.4, but the section has now been renumbered as PRU 2.3. This new section provides guidance comprising suggestions for the risks which firms should consider and how they might be assessed through stress tests, scenario analyses or other models.
5. Most respondents considered the guidance in PRU 2.3 to be helpful. However, there was some division as to whether greater or less detail would be most helpful. The extent to which the stress and scenarios tests are prescriptive was generally felt to be appropriate and that they do not require greater quantification, but some smaller non-life firms sought more prescription in the interests of cost. The possibility of publishing information on the distribution of ICG across the industry received support.
6. Respondents expressed concern that the level of detail will lead to more work than necessary being undertaken by auditors and actuaries. They also suggested that:
 - a survival probability should be stated as an objective, and that means other than additional capital may be the most appropriate way to manage some risks;
 - guidance should be reviewed and updated in the light of implementation;
 - clarification was requested on FSA expectations in relation to group risk which is not listed in PRU 1.2.31;

- the actuarial profession should develop technical standards for the ICA for life insurance firms;
- it is difficult to aggregate results reliably when capital requirements are derived by a series of stress tests;
- references to three- to five-year time horizons in the guidance is not consistent with the time horizon being at the discretion of senior management; and
- the categorisation of some individual risks should be amended, for example to ensure consistency with categorisation elsewhere in CP195

Our response: On balance we believe the guidance to be appropriate and, in the light of the support for this view, we intend to keep this section.

In both CPs we took a measured decision not to include any mandatory stress tests or quantitative factors that firms should adopt. We did this because we considered that a prescriptive approach would detract from the main purpose of the ICAS objectives: that the capital assessment be tailored to each firm's risks. On balance we are convinced of this approach and do not intend to supplement the existing guidance in PRU 2.3. We have already commented in Chapter 5 on the overall confidence level we consider appropriate for ICG, and our 'near final' text has been amended to make this more explicit.

A firm is primarily responsible for the ICA method it applies. We are more concerned with how a firm identifies and appropriately addresses its individual risks than their precise categorisation. We will seek evidence that proper consideration has been given to the risk areas that ICAS should cover. This will be one of the key interfaces between the ICAS and our risk assessment framework (Arrow). If a firm assesses that it has material exposure resulting from its relationships within a group structure, or indeed as a result of other risk exposures not covered in PRU 1.2.21, we would expect these to be addressed within its ICA. We recognise that assessing and quantifying the affects of correlations between stress scenarios is complex and would expect firms to be able to explain their approach to us and how they have formed a judgement of what is reasonable.

Professional guidance is a matter for the professional bodies, but we understand and welcome the fact that development of actuarial technical standards is in progress.

We will keep under review the appropriateness of publishing summary information about industry ICG levels. But we have commented in Chapter 5 on our intended timetable for ICA reviews, which may extend over the next few years, and so we do not expect that it would be appropriate to publish such information for some time.

Our response to the following question addresses the concerns in relation to smaller firms.

Question 17 in CP190 and Question 16 in CP195: Is the broad ICAS framework practical and appropriate?

7. PRU 2.3 also set out guidance to the effect that when conducting their ICAs, insurers may wish to consider the extent to which the MCR or ECR is adequate for their circumstances. A firm should therefore take account of the nature and extent of differences between its risk profile and the risks addressed by the MCR, or ECR.
8. The vast majority of respondents were largely supportive of the concept. They felt the broad ICAS framework to be a sensible and appropriate way to help us to achieve our objectives. It was acknowledged that the ICAS process will evolve over a number of years, and should encourage continuous refinement of the process for assessing adequacy of financial resources, especially in relation to operational risks. Nevertheless, smaller firms in particular expressed concerns that the process had the potential to grow and become overly complex and expensive.
9. Another respondent suggested that additional clarity was needed on unit-linked and non-profit companies and that an example of an ICA calculation for a life company would have been helpful. Others expressed concern over the availability of sufficiently skilled resource within both firms and the FSA to implement the ICAS framework fully.
10. Some further points raised were that:
 - the ICA might reflect risks to achieving the firm's objectives, whilst ICG would reflect risks to our statutory objectives, resulting in potential inconsistencies;
 - inconsistencies across the market are inevitable and we should seek to minimise these;
 - there needs to be an appropriate balance between the intended complexity of the ICA calculation and the frequency of calculation;
 - clarification was sought as to whether capital needs to be held for the repayment of subordinated debt and other liabilities designed to be capital; and
 - careful consideration would need to be given to the timetable for more specific rules should these be considered appropriate.

Our response: We are encouraged by the support from respondents for the proposed ICAS regime and the concepts underpinning it. We are keen to ensure that the ICAS process is applied on a proportionate basis to all firms and that the costs to small and medium sized firms are not unduly high. We will look to establish procedures to minimise inconsistency between firms and expect these to evolve over time along with firms' own processes.

We agree that a firm may wish to have its own capital processes aligned to its business objectives. Even so, it is the firm that is primarily responsible for ensuring that it also has adequate capital for regulatory purposes. And so, as we have mentioned in Chapter 5, in addition to any process a firm has for business planning, it should prepare its ICA on a basis which is consistent with our desired confidence level for ICG. Our guidance in PRU2.3 has been amended to reflect this. For our response on the frequency of ICA calculation, please see Q19. We would also expect firms in carrying out their ICA calculations to assess the robustness of their capital base to changing circumstances and to identify future triggers for reassessing adequacy if business plans are not being achieved. There is no requirement to submit these assessments to us but, as stated in PRU 2.3, we may request them periodically.

We have provided additional rules and guidance on the treatment of subordinated liabilities related to items designed to provide capital resources to meet the ECR (particularly for with-profits insurers) in PRU 2.2. We would expect a similar approach to be adopted for such liabilities by firms in their ICAs.

Question 18 in CP190: Do you have any comments on our approach and timetable for giving ICG initially to insurers?

11. In CP190 we set out that during 2004 and 2005 we would review the initial self-assessment of non-life insurers and would be giving individual capital guidance (ICGs) based on these reviews. Where firms develop more sophisticated approaches and models as part of their own risk management processes, we said that we would consider the results as part of our assessment of capital adequacy. In some cases these may provide a better starting point than the ECR so that ICG could be below the ECR level.
12. Responses to this question were varied. Many firms considered the timetable suitable, others looked for more clarity. A number of respondents emphasised the need for us to appreciate that some of the complex internal models would not be available until 2005. Many responses stressed the importance of a consistent application of ICAS where firms can have the confidence that the incentives for good risk management will operate effectively, and that there will be no competitive disadvantage in engaging in a full and frank risk assessment.

Our response: We have commented in Chapter 5 on our intended timetable for ICA reviews and that for giving ICG.

Question 19 in CP190 and question 17 in CP195: Do you have any comments on the practical operation of the ICAS regime (valuation, capital models, public information or other issues)?

13. These open ended questions generated a number of comments, some of which were repeated in response to other questions. Some respondents asked for clarification on what would constitute an 'independent review' of a model, and the type of external party that could perform it. Others called for all ICG and ICAS information to be kept confidential to avoid speculation and potential reputation damage.
14. Another respondent asked for guidance on how often firms will be expected to re-assess their ICA and whether a material change in a firm's ICA would routinely lead to a re-assessment of the ICG.
15. Two respondents questioned the statements made in both CP190 and CP195 concerning firms' likely inability to convince us that capital requirements based on the ECR (now to be a 'soft' test for general insurers, but a 'hard' test for relevant life insurers) were too high, based on results from their internal models. They were fearful that this could prejudice the framework.
16. Many other points were mentioned that we do not seek to summarise here, save two:
 - the possibility of the phased introduction of ICG leading to competitive advantage for some firms; and
 - the method by which ICG will be expressed, for example as a proportion of CRR.

Our response: Each firm is first and foremost responsible for determining the appropriate method to compile its ICA, and for identifying its material business risks. We will review and challenge submissions in the light of information that is available to us. As we have discussed in Chapter 5, the ICG process will be aligned to our risk assessment framework, and dialogue between us and the firm will aid transparency.

We expect firms to undertake regular assessments which are in their view adequate for the nature and size of their businesses. These should be of a frequency to enable them to monitor the risks to which their businesses are exposed and to ensure that they hold adequate financial resources to meet their liabilities as they fall due.

In general it is our intention to review a firm's ICA in line with its Arrow risk assessment. The Arrow cycle is set using a risk-based approach. This may vary from 12 to 36 months. If a firm were to notify us of a material change in its ICA, which may have been prompted by a change in its risk profile, this may trigger an Arrow review and subsequently a reassessment of its ICG.

Where a firm considers that ICG should be below the ECR level, we are likely to place greater reliance on a model if it is supported by an external, independent review from consultants or other such specialists of appropriate expertise.

As we have set out earlier, we are not intending to implement the ECR for non-life insurers as a binding capital requirement in the near term. Consequently, where a

non-life firm considers that its ICG should be below the ECR level, then it will not have to apply for a waiver from the ECR. Nevertheless, in such cases we would expect firms to have a robust capital model to support a proposal for an ICG below the level of the ECR. ICG for non-life firms will usually be expressed as a percentage of ECR.

We have not yet determined whether ICG for life insurers should be expressed as a proportion of the overall capital resources requirement, an absolute amount, or some other measure. As mentioned in the response to Question 16 above, we are setting up procedures to minimise inconsistency and so the potential competitive distortion, but we expect the best approach to emerge as we review the first assessments presented by life insurers. Life firms may choose to apply a twin peaks type approach to their entire business, but in any event will need to consider all material risks to their business for their ICA.

Question 19 in CP195 and question 21 in CP190. Is our approach to individual capital adequacy assessments for firms that are members of groups clear and appropriate?

17. In the consultation papers we explained that the obligation to meet the ICAS rules falls not only on relevant regulated firms within a group, but on each regulated firm individually. But, for many groups the risk assessment function and capital planning will be performed at a group level or along business lines rather than legal entity lines. We do not want to discourage such an approach as we see considerable benefits in regulatory capital assessments being integrated with the management processes used within a business. However, the approach must result in an assessment of each firm's adequate capital level. We stated that we will take into account any detailed evidence that demonstrates that diversification has reduced risks, though this would depend on transferability of capital within the group and whether any group member faces higher risks because of its membership of a group.
18. Most, but not all, respondents found the guidance clear and appropriate, however, a number expressed the view that the proposals do not adequately address the impact of diversification.
19. Other points raised were:
 - a stated policy on survival probability would reduce the prospects or perception of a lack of comparability or of excessive capital requirements at group level;
 - it is appropriate for the FSA to retain some flexibility to deal with variations in group structures that occur in practice;
 - that consistency in approach and in timescales with our intentions for implementing Financial Conglomerate rules may be a cause for concern;

- that it would seem reasonable that binding legal commitments from parent undertakings might in some circumstances appropriately be taken into account;
- that the requirement in some cases for more assets to be allocated to the with-profits fund could reduce the surplus assets available within parent undertaking solvency margin calculations; and
- further guidance was needed on how groups might carry out capital assessments at group level and allocate the result to undertakings, without carrying out the solo level calculations too.

Our response: We have commented in Chapter 5 on the overall confidence level that we consider appropriate for ICG.

We are encouraged that the guidance appears appropriate in the light of the need to be flexible for individual groups. In presenting their ICA, firms will have the opportunity to explain how features such as parental support and diversification benefits might provide grounds for a lower level of group ICG and solo ICG. But lower ICG will only be appropriate if we are satisfied that capital would in practice be transferable within the group in conditions of financial stress. We consider it unlikely that groups adopting an approach that is based on a group-level capital assessment (i.e. assuming full, unrestricted, transferability as if the group were a single legal entity operating in a single jurisdiction) and then allocating the result to undertakings would be able to satisfy us that the group risks and transferability issues had been adequately considered. We expect groups (and firms within groups) to be able to present an assessment of the capital that each firm would consider adequate were it not part of the group, against which we can evaluate the transferability issues. We consider that this is necessary to ensure consistency with the principles behind the Insurance Groups Directive and Financial Conglomerates Directive.

Q20: Is the annex to PRU 2.3 helpful; should it be kept in the proposed handbook text?

20. We are aware that non-life insurers vary considerably in size and sophistication. With smaller firms in mind, we have included as an annex to PRU 2.3 an illustration of how such a firm might approach the capital assessment requirements. We focussed in particular on the degree of sophistication required for stress and scenario tests to comply with our rules.
21. Nearly all the respondents to this question considered the annex helpful and requested that it be kept. Many added that as a theoretical case study it provided useful background, should stimulate thinking about the approach to be taken in practice and was particularly useful for smaller firms.

Our response: Given these positive comments we intend to keep the Annex to PRU 2.3.

Feedback on responses to directors' report, audit and actuary proposals in CP195 & CP202

Q21: Is it appropriate to extend the scope of the audit report to realistic liabilities and the WPICC for twin peaks firms? Is it also appropriate to extend the scope of the reviewing actuary's personal opinion?

1. There was widespread agreement that the scope of audit should be extended to include the realistic reporting forms 18 and 19 and the WPICC calculation for twin peaks firms. However, concerns were expressed about auditor and actuarial reporting in respect of the valuation report. Respondents objected to the strength of audit opinion required, and felt this would entail a great amount of audit work with consequent costs to the industry. It was also felt that the wording of the reviewing actuary's opinion was particularly onerous in requiring too much certainty. A perceived potential consequence of the proposed new reporting regime was the more frequent occurrence of qualified audit reports. The need for new professional guidelines for both actuaries and auditors was also emphasised, as was the need for clarity on certain issues such as who would appoint the reviewing actuary.
2. Some respondents also commented on our proposals to include an independent actuary's opinion as part of the auditors' review of the valuation report. Of particular concern were the issues of clarity of responsibility and apportionment of liability between auditor and actuary. There was a strong preference expressed by many for a single audit report with expert advice sought from an independent actuary, but with no separate public actuarial opinion given in the audit report (in line with current audit practice guidelines). There was also some support for the suggestion that the actuarial function should provide a certificate covering the issues reported on in the reviewing actuary's opinion, which would then be subject to independent public review.

Our response: In response to industry concerns over the phrasing of the audit opinion, we have made some changes to the draft rules at Appendix 1, to bring the opinion more into line with the form of words currently used. We have also added text

and guidance to provide more clarity on specific issues raised by respondents. We acknowledge firms' concerns that the new audit regime for insurers increases audit costs. But, we remain convinced that the costs have been adequately considered in our cost benefit analysis, and that the industry as a whole views the extension of the audit scope as a necessary measure. We continue to consider it appropriate that the disclosures of the main valuation and capital methods and assumptions that are found in the valuation reports should be audited as these underpin firms' liability provisions and calculations of required capital.

We have already stated in Chapter 6 that we recognise the concerns about lack of clarity regarding the respective roles of the auditor and the reviewing actuary, and we outline there the changes we have made in response.

We have engaged in discussions with both the Auditing Practices Board and the Institute and Faculty Actuaries as they have commenced reviewing their professional guidelines.

Feedback on the directors' report

3. Most respondents welcomed the exclusion of the directors' certificate from the scope of the audit report. However, some took the opportunity to comment more generally on the practical implications of our proposed requirements. It was suggested that firms would not be able to make an unequivocal statement on full compliance with IPRU(INS), SYSC, PRIN and PRU because of the potential for non-material breaches. In particular, one respondent noted that the requirements in SUP do not envisage firms notifying us of insignificant rule breaches. It would therefore appear inconsistent to apply a more exacting test for the public disclosure.

Our response: Although we would strongly encourage firms to aim for full compliance with our requirements, we recognise that breaches will vary in their significance. It is important to maintain the signalling value of a statement's omission from the certificate, so the expectation is that most firms should be in a position to assert their compliance, irrespective of technical infringements. We are therefore introducing a materiality concept to the compliance test similar to that applied in our general notification requirements. This will require firms to consider the significance of any breach in relation to the potential financial loss to policyholders and whether it is symptomatic of wider control failings. A firm will be able to make a positive statement on its compliance if it considers that no significant breaches have occurred or are likely to occur in the future.

Feedback on responses to realistic forms in CP195

Q20: Are the realistic reporting forms and associated instructions clear and is the level of disclosure appropriate?

1. Almost all agreed that the forms, their instructions and the valuation report were clear, though we received a number of comments on their content. Some comments suggested that there should be modification of the forms, for example to allow the inclusion of assets supporting the with-profits fund which are located outside the fund. In addition, it was commented that the breakdown of liabilities on form 19 should be more summarised as there was potential for firms to interpret the current split differently, thereby making it more difficult to compare results between firms. Some respondents noted the need for consequential changes to form 9. Firms also asked that they should not be required to give 2003 comparatives in the first round of mandatory public reporting, for financial years ending on, or after 31 December 2004.
2. The major comments that we received were:
 - for twin peaks firms, realistic reporting should be the focus of the return. As a consequence, reporting of the regulatory peak should be reined back;
 - rather than showing the with-profits benefits reserve and the WPICC, realistic reporting should distinguish clearly between guaranteed and discretionary benefits; and
 - while a number agreed that the level of disclosure required was about right, if realistic reporting were the main focus, a number conversely commented that disclosure required by the valuation report in IPRU Appendix 9.4A was excessive. There was concern that disclosure in respect of models could be commercially sensitive; that disclosure of management actions assumed for provisioning might allow policyholders to select against the fund; and that some of the valuation disclosures could be confusing.

Our response: We have made some modifications to the forms, to reflect the changes to 'twin peaks' that we have discussed in Chapter 3, and these include a change to

bring in, to the extent permitted, the embedded value of non-profit business outside the with-profits fund. In order to show any other assets outside the with-profits fund as backing with-profits liabilities, the firm will need to seek a waiver or rule modification under S148 FSMA. This is discussed further in Annex 3 (our response to Q5). Further non-profit and shareholder assets that a firm potentially has available to cover with-profits capital requirements, but which are not currently required to cover the RCM, may now be separately disclosed at the foot of form 19. But broadly we remain of the view that what was proposed in CP195 is generally appropriate and so the forms remain in substance much as set out in that CP. This is because we have maintained a disclosure approach rather than adding lots of additional detailed rules and guidance on realistic methods to be adopted. Most firms agreed that they did not want too detailed a level of prescription in our realistic rules.

We agree that realistic reporting of with-profits business should be a focus for users of the annual return, which is why we have required detailed disclosures. And we also agree that ultimately it should be possible to reduce reporting on the regulatory peak for firms that also report realistically. But, we are of the view that there should be a period of parallel running, while firms do both, as users of the return become more familiar with the realistic approach, and firms' realistic methods continue to evolve. Reporting that clearly demonstrates how firms are meeting Directive requirements, and the need to continue to report non-profit business on a regulatory basis are also factors that have a bearing on this decision. We will be considering reporting requirements more generally in the light of our experience of implementing the ICAS framework, as well as once IAS disclosure requirements are finalised, and we expect a review of the annual reporting package to form part of this work. We will also consider any with-profits disclosures arising from the Accounting Standards Board's work following on from the Penrose Review.

We have also considered the comment from two respondents that reporting of liabilities should split a realistic value of guarantees from the amount provided by a firm for future discretionary benefits. Forms 18 and 19 have been developed reflecting the asset share approach that is commonly used by twin peaks firms, and so they reflect how firms have been managing this business in practice. In addition, in the run up to including these forms in the public annual reporting package for the first time, firms have been completing them for us privately. So, we consider that it would be appropriate to maintain the forms on the current basis. But, while we do not consider it appropriate at this stage to mandate disclosure of the realistic value of a firm's contractual obligations, we have made an amendment to permit firms the option of making this disclosure in their realistic valuation report. We note also that, for twin peaks firms, the regulatory peak gives a prudent actuarial valuation of contractual obligations.

We also agree that there is a need for consequential changes to higher order forms (such as form 9) in the reporting pack, and we will not require firms to disclose 2003 comparatives in forms 18 and 19. We will be consulting on consequential changes to higher order forms and transitional provisions in our July 2004 quarterly CP.

Confirmation of CBA for definition of capital, life audit, ICAS & non-life ECR

Feedback on responses to the CBA in CP195 and CP202

13. We comment on the feedback that we received on the CBA relating to the extension of the audit scope to cover policyholder liabilities in Annex 6.

Confirmation of the CBA in CP190

14. As part of this Policy statement we are publishing amended rules and guidance for non-life insurers. A revised CBA would be required under the Financial Services and Markets only if the CP190 CBA were now considered to be materially inaccurate, or were our subsequent revisions to CP190 proposed rules and guidance likely to materially affect the CBA published in CP190. As we have set out in preceding chapters of this Policy Statement we are, by and large, confirming our CP190 proposals. Where the rules are unchanged, the CBA in CP190 still stands. In addition, we do not consider that the limited detailed changes from CP190 that are reflected in our amended rules and guidance do give rise to materially different costs and benefits from those published there. So, we consider that the CBA in Annex 3 of CP190 remains appropriate. We set out below some feedback on how we reached this conclusion.

General insurance ECR

15. As regards the general insurance ECR proposals, CP190 set out two alternative proposed sets of rules. One set required firms only to calculate the ECR and report it (so that we could use it as a benchmark against which to compare their ICA); the second proposed the ECR as a 'hard' capital requirement (subject to possible waiver on application).

16. We confirm in chapter 2 of this PS our intention to implement the requirement for firms to calculate and report the ECR, so that the ECR can be used as a benchmark in ICAS discussions. This therefore aligns with option 1 in CP190. If as a result of our intention to review this decision in 2006, we propose in future to change the ECR to a 'hard' capital requirement, we would re-consult on our revised proposals, and publish a revised CBA.
17. The only significant modification we have made to calculation of the general insurance ECR is to alter the capital charge factor applicable to investments in collective investment schemes that invest only in money market funds from 16% to 0%. Insofar as the ECR, as a benchmark, affects an insurers' investment decisions, this will avoid such money market funds from becoming unattractive investments despite their comparatively low risk. So it will avoid market distortions being introduced that put such money market funds at a competitive disadvantage.

Definition of capital

18. As we have explained in chapter 4, we are broadly confirming our proposed definition of capital, though we have made minor modifications to the classification and limits placed on some forms of capital. But our main proposal in CP190 and CP195 was the introduction of 'innovative tier 1' capital for insurers (which mirrors that available to banks). Such capital instruments and structures are tax efficient and so represent a cheaper form of tier 1 capital than previously available forms. However, due to Directive constraints, these hybrid debt instruments cannot be used to meet the MCR. We are confirming the availability of innovative tier 1 capital to insurers, to meet the ECR and ICG, in this PS.
19. The approach taken in the previous cost benefit analyses was to apply a cost of capital assuming a 3.5% marginal cost of equity capital (above the risk free rate). This assumes that all of the capital raised by firms to meet an ECR requirement or ICG would be in the form of tier 1 equity and reserves. However, up to 15% of tier 1 capital could be in the form of innovative tier 1 capital, the costs of which are allowable at a corporation tax rate of 30%. So we previously overstated the costs of our proposals.
20. We comment in our feedback on responses to question 14, in Chapter 4, on the other minor changes we have made to capital definitions and limits, but conclude that they will have no material impact on capital costs or behaviours.

ICAS

21. We have not made any significant changes to our ICAS proposals, so the cost benefit analyses in CP190 and CP195 are still appropriate.

Summary of changes to PSB text that was not in CP190 or CP195

Prudential Categories

1. We have now updated our approach to the categorisation of firms within the Integrated Prudential Sourcebook (PSB). Originally, these were put forward based on distinguishing firms according to their risk profile. However, we have now moved to an approach that is based on EU Directive driven categories, plus type of business where appropriate.
2. This is being done because to a greater degree than originally anticipated the PSB is going to have to implement a number of EU Directives with different applications. Also, the extension of our scope of regulation makes it impractical to adopt a pure risk based approach across the categories. A Directive plus type of business approach should help ensure that policy will take into account the particular characteristics of the many sets of firms to which the PSB will apply. This should help with Directive compliance, super-equivalence assessment and cost benefit analysis.
3. As before, most of the new categorisations will be permission based. By way of example, whereas the previous “PRU Category 1” encompassed a firm whose permission included accepting deposits and was a bank or a building society, this is now replaced by the category “Credit Institution”. The table below sets out the updated prudential categories with a brief summary description.

Category	Summary description
Insurer	Insurance firms excluding Lloyd's
Credit institution	Banks and building societies.
own account dealer	A firm with permission to deal as principal other than only to fulfil customer orders.
Matched principal dealer	A firm with permission to deal as principal only to fulfil customer orders.
Broker/manager	A firm with permission for dealing as agent or managing investments
adviser/arranger	A firm with permission for arranging/advising
limited scope arranger	An adviser/arranger which is subject to a requirement that it may only act as an arranger for transactions in securities to be executed by a limited range of firms.
UCITS management company	A firm which is either a UCITS firm or a UCITS investment firm.

4. The effect of these changes on insurers is minimal: the new term 'insurer' is a direct replacement for the previous 'PRU category 2A firm'.

PRU 1.3: valuation rules

5. PRU 1.3 defines the general requirements for the valuation of assets, liabilities and income statement items for insurance firms. The chapter is a revision of PRAG 5, on which we consulted in CP97.
6. The original PRAG 5 in CP 97 defined the general requirements for the valuation of assets, liabilities and income statement items for all firms within the scope of the PSB. The revised chapter now only contains those rules and guidance applicable to insurance firms; rules and guidance specific to the other firms will be incorporated as when these firms form part of the PSB regime.
7. In addition to removing rules and guidance that do not apply to insurance firms the chapter has undergone other drafting and formatting revisions to clarify certain rules and also in response to the CP 97 consultation. The main changes are summarised below:

Rules and Guidance moved to other chapters

8. The original version of PRAG 5 went beyond the statement of general principles for valuation and included among other things a list of admissible assets for capital purposes. Responses to CP 97 prompted us to transfer these

rules and guidance to other PSB chapters. The transfers affected chapters which we consulted on in CP 195 noted below:

Admissible assets	The list of admissible assets has been transferred to the Annex to PRU 2.2. Concentration Limits are now in PRU 3.2.
Assets already taken into account in technical provisions	Assets already taken into account in technical provisions are now covered by the provisions in PRU 7.2.

Additional text and Guidance

9. We have also made other text changes to clarify certain rules and guidance:
 - Rules on the valuation of financial instruments - PRAG 5 required financial assets and liabilities to be measured at their fair value. To avoid confusion over the scope of the assets and liabilities to which this requirement applied we have replaced this rule with more detailed market valuation rules that apply only to a specified list of financial instruments; and
 - Co-insurance valuation rules - We have added rules and definitions on co-insurance consistent with the rules contained in IPRU (ins).

PRU 3.2: Credit risk in insurance

10. This section, formerly PRCR10, was consulted on in CP97 and CP143. The main purpose of re-consulting in CP143 was to refine the treatment of large reinsurance exposures. Feedback on the responses that we received to those consultations was given in CP143 and CP195, respectively.
11. The section sets out rules and guidance relating to four main requirements:
 - a general requirement to manage credit risk;
 - Directive driven asset and counterparty concentration limits;
 - large exposures requirements relating to reinsurance exposures; and
 - large exposure requirements relating to other exposures.
12. In the intervening period since consultation, we have worked to clarify some of our requirements, in response to feedback that we received. For example, we have brought together into the credit risk section all of the Directive concentration limits that were formerly divided between the market and credit risk sections. In addition, we have sought to make clearer the treatment of synthetic exposures where a firm has derivatives.

13. PSB text setting out how the Directive limits apply on an adjusted solo basis will form part of PRU 8.3 (Insurance Groups). PRU 8.3 is not appended to this Policy Statement, but it will be published in July 2004, when we publish the Policy Statement for CP204.

PRU 7.6: Internal contagion risk

14. This section was consulted on in CP97 as PRIR5. It has been renamed PRU 7.6, and revised to take account of responses to CP97, as well as updated to reflect intervening consultations on requirements in respect of with-profits business.
15. 'Internal contagion' risk is the risk that losses or liabilities arising from one activity within a firm or group might deplete or divert financial resources held to meet liabilities from another activity within the firm.
16. The chapter covers the risk that arises in particular where a firm carries on:
- both insurance and non-insurance activities;
 - two or more different types of insurance activity; or
 - insurance activities from offices or branches located in both the United Kingdom and overseas.
17. PRU 7.6.10 continue to reflect a requirement in the European Directives that insurers should not carry on any commercial business other than insurance business and operations arising directly therefrom. A number of respondents to CP97 sought further guidance on this issue. We expect to consult on guidance in due course.
18. Provisions for the ring fencing of with profits business and the fair treatment of with profits policyholders have been modified to take account of intervening developments. Material that was in PRIR 5 has been superseded by the CP195 twin peaks approach to calculating liability provisions and capital for with-profits business, which we are confirming in this Policy Statement, and our changes to the Conduct of Business sourcebook, including the requirement for PPFM. We expect that rules and guidance on treating with profits policyholders fairly, (on which we consulted in CP207 and which will be the subject of further consultation in Summer 2004) will result in further changes to COBS.
19. We have clarified the financial resource requirements for UK branches of non-EEA firms: the notional capital requirement for UK branches of non-EEA firms for which the UK is lead regulator, is based the application of on UK rules.

Appendix 1

Integrated Prudential Sourcebook (PRU) and other Handbook text

Introduction

The following table sets out which PRU and other Handbook text is appended to this Policy Statement. Systems and controls and group requirements will also form part of the PSB, and will be applicable to insurers, but are not appended to this Policy Statement. This table therefore also tells insurers where they may find the relevant text relating to those requirements. Firms should also note that, as we have discussed in Chapter one of this Policy Statement, we will consult on transitional arrangements for insurers in our July 2004 quarterly CP.

New Ref	Chapter (old reference)	
PRU	Application and general requirements (PRAG)	Insurer
1.1	Application, purpose and content (PRAG 1)	Scope of application currently set out in each section
1.2	Adequacy of financial resources (PRAG 4)	** *
1.3	Valuation (PRAG 5)	** *
1.4	Prudential systems and controls (PRAG 6)	** +
	Capital (PRCR)	Insurer
2.1	Calculation of capital resources requirements (PRCA 1)	** *
2.2	Capital resources (PRCA 2)	** *
2.3	Individual capital assessment (new)	** *
	Credit risk (PRCR)	Insurer
3.1	Credit risk systems and controls (PRCR 1)	** +
3.2	Credit risk in insurance funds (PRCR 10)	** *
3.3	Asset-related capital requirement (was part of PRU 3.2)	** *
	Market risk (PRMR)	Insurer
4.1	Market risk systems and controls (PRMR 1)	** +
4.2	Market risk in insurance funds (PRMR 11)	** *
4.3	Derivatives in insurance funds (PRMR 12)	** *
	Liquidity risk (PRLR)	Insurer
5.1	Liquidity risk systems and controls	** +
	Operational risk (PROR)	Insurer
6.1	Operational risk systems and controls (PROR 1)	** +

	Outsourcing (PROR 2)	■
	Insurance risk (PRIR)	Insurer
7.1	Insurance risk systems and controls (PRIR 1)	**+
7.2	Capital resources requirements and technical provisions for insurance business (PRIR 2)	***
7.3	Mathematical reserves (PRIR 3)	***
7.4	With profits insurance capital component (new)	***
7.5	Equalisation provisions (PRIR 4)	***
7.6	Internal-contagion risk (PRIR 5)	***
7.7	Lloyd's	☾
	Group risk (PRGR)	Insurer
	Introduction (PRGR 1)	■
8.1	Systems and controls (PRGR 2)	**☾
8.2	Capital requirements: deposit taking and investment business groups (PRGR 3)	N/a
8.3	Capital requirements: insurance and reinsurance firms (PRGR 4)	☾
8.4	Capital requirements: cross-sector groups (PRGR 5)	☾
	Glossary	☐

**	Q4 2004 implementation (PRU 8.1 implementation is for groups and PRU 1.3 will be updated at each stage)
■	Deleted as a separate chapter
*	Full text included in this Policy Statement
☾	Policy statement to CP204 expected to be published in July 2004
+	See policy statement October 2003 for near final text including feedback to CPs 97, 128 and 142 http://www.fsa.gov.uk/pubs/policy/ps_pru.pdf
☐	Partial text included in this policy statement
☾	See CP04/07 for latest draft text including feedback to CP178 http://www.fsa.gov.uk/pubs/cp/cp04_07.pdf

In the pages that follow the Handbook text for the Prudential Handbook (PRU) is shown in its latest form, as we intend to "switch on" these requirements when we implement the PSB. Where text that forms part of IPRU(INS) or SUP is to be amended, underlining indicates additions to the current text whereas striking through indicates deleted text.

1.2 Adequacy of financial resources

Application

- 1.2.1 R *PRU 1.2 applies to insurers referred to as firms in this section.*
- 1.2.2 R Subject to *PRU 1.2.3R to PRU 1.2.6R*, *PRU 1.2* also applies to a *firm* that falls into any of the following categories, but only insofar as *PRU 1.2* relates to *liquidity risk* (including the systems, processes and resources required by *PRU 1.2* in respect of *liquidity risk*):
- (1) a *bank* or *building society*;
 - (2) an *own account dealer* (other than a *venture capital firm*);
 - (3) an *incoming EEA firm* that:
 - (a) is a *full BCD credit institution*; and
 - (b) has a *branch* or *branches* in the *United Kingdom*; and
 - (4) an *overseas firm* that satisfies the following conditions:
 - (a) it is a *bank*;
 - (b) it is a *lead-regulated firm*;
 - (c) it is not an *incoming EEA firm*; and
 - (d) it has a *branch* or *branches* in the *United Kingdom*.
- 1.2.3 R An *overseas firm* that is a *lead-regulated firm* is excluded from *PRU 1.2.2R* unless it falls into *PRU 1.2.2R(4)*.
- 1.2.4 R
- (1) In the case of a *firm* falling into *PRU 1.2.2R(3)*, *PRU 1.2* only applies with respect to the *branch* or *branches* referred to in *PRU 1.2.2R(3)*.
 - (2) In the case of a *firm* falling into *PRU 1.2.2R(4)* *PRU 1.2* only applies with respect to the *branch* or *branches* referred to in *PRU 1.2.2R(4)*.
- 1.2.5 R *PRU 1.2* does not apply to:
- (1) a *non-directive friendly society*;
 - (2) a *firm* which is a *Swiss general insurer*;
 - (3) a *firm* which is an *EEA-deposit insurer*;
 - (4) a *UCITS qualifier*;

- (5) an *OPS firm*;
 - (6) an *ICVC*;
 - (7) a *firm* which is an *incoming EEA firm*, except that it does apply to such a *firm* if, and only if, it satisfies the conditions in *PRU 1.2.2R(3)*; or
 - (8) a *firm* which is an *incoming Treaty firm*.
- 1.2.6 R *PRU 1.2* only applies to an *incoming EEA firm* to the extent that the relevant matter is not reserved by the relevant *Single Market Directive* to the *firm's Home State regulator*.
- 1.2.7 R (1) *PRU 1.2* applies to a *firm* in relation to the whole of its business, except where a particular provision provides for a narrower scope.
- (2) Where a *firm* carries on both *long-term insurance business* and *general insurance business*, *PRU 1.2* applies separately to each type of business.
- 1.2.8 G The *guidance* in *PRU 1.2* is drafted with respect to a *firm* to which *PRU 1.2* and the other provisions of *PRU* referred to in *PRU 1.2* apply in full. The *guidance* in *PRU 1.2* is also applicable to a *firm* that falls into *PRU 1.2.2R*. However the *guidance* in *PRU 1.2*, as it applies to such a *firm*, should be read accordingly. In particular, the *guidance* in *PRU 1.2* only applies to such a *firm* in respect of *liquidity risk*.
- 1.2.9 G In the case of an *incoming EEA firm* that is a *full BCD credit institution* and of an *overseas firm* that is a *lead-regulated firm*, *PRU 1.2* only applies to its *United Kingdom branch*. However, as a *branch* is not itself a legal entity separate from the rest of a *firm*, this restriction does not mean that the rest of the *firm* can necessarily be left out of account when considering compliance with *PRU 1.2*. For example, the availability of the *branch's* liquidity resources may be affected by general liquidity problems in the *firm*. Likewise, there may be liquidity resources elsewhere in the *firm* that are available to meet liquidity problems in the *branch*.
- 1.2.10 G One factor that may affect the degree to which it is necessary to take into account the *firm* as a whole is the extent to which the *firm* manages the liquidity of the *branch* on an autonomous basis, or includes the *branch* within integrated liquidity management of the *firm* as a whole. In the latter case, for instance, the requirement in *PRU 1.2.35R* to carry out scenario analyses may be satisfied by the *firm* meeting similar requirements set by the regulator in its home country in respect of the *firm* as whole, provided that the *firm* separately identifies the impacts on the *United Kingdom branch* of the scenarios analysed. However in the case of a *full BCD credit institution*, the application of *PRU 1.2* is further restricted by *PRU 1.2.6R*.
- 1.2.11 G The scope of application of *PRU 1.2* is not restricted to *firms* that are subject to the relevant EC directives. It applies, for example, to pure reinsurers.
- 1.2.12 G The adequacy of a *firm's* financial resources needs to be assessed in relation to all the activities of the *firm* and the risks to which they give rise.
- 1.2.13 G The requirements in *PRU 1.2* apply to a *firm* on a solo basis.

Purpose

- 1.2.14** G This section amplifies *Principle 4*, under which a *firm* must maintain adequate financial resources. It is concerned with the adequacy of the financial resources which a *firm* needs to hold in order to be able to meet its liabilities as they fall due. These resources include both capital and liquidity resources. *PRU 2* sets out provisions relating to the adequacy of *capital resources*. *PRU 5* contains provisions relating to liquidity.
- 1.2.15** G This section therefore introduces *rules* requiring a *firm* to identify and assess risks to its being able to meet its liabilities as they fall due, how it intends to deal with those risks, and the amount and nature of financial resources the *firm* considers necessary. These assessments should be documented so that they can be easily reviewed by the *FSA* as part of the *FSA*'s assessment of the adequacy of *capital resources*.
- 1.2.16** G This section also introduces *rules* requiring a *firm* to carry out appropriate stress tests and scenario analyses for the risks it has previously identified and to establish the amount of financial resources needed in each of the circumstances and events considered in carrying out the stress tests and scenario analyses.
- 1.2.17** G The adequacy of a *firm's capital resources* needs to be assessed both by the *firm* and the *FSA*. This is done, by the *FSA*, through comparing the *firm's capital resource requirements* with its *capital resources* and by review of a *firm's* processes and systems for assessing capital needs, the results of the *firm's* assessments, and other information available to the *FSA* on the risks faced by the *firm*.
- 1.2.18** G *PRU 2.1* sets out the minimum *capital resources requirements* for a *firm*. *PRU 2.2* sets out how capital is defined and measured for the purpose of meeting the requirements of *PRU 2.1*.
- 1.2.19** G *PRU 2.3* sets out detailed *guidance* on how *firms* could assess the adequacy of their *capital resources* both to comply with the *rules* set out in this section and to enable the *FSA* to assess better whether the minimum *capital resources requirements* of *PRU 2.1* are appropriate. The more thorough, objective, and prudent a *firm's* capital assessment is and can be demonstrated as being, the more reliance the *FSA* will be able to place on the results of that assessment. The *FSA* will consider the appropriateness of the *firm's* capital assessment to establish the level of *capital resources* the *firm* needs. This may result in the *FSA's* assessment of a *firm's capital resources* needs being lower or higher than would otherwise be the case.
- 1.2.20** G *PRU 5.1* sets out general systems and controls provisions for *liquidity risk*.
- 1.2.21** G *PRU 1.4* sets out *rules* and *guidance* on the establishment and maintenance of systems and controls. In particular *PRU 1.4.6G* states that adequate financial resources and adequate systems and controls are necessary for the effective management of prudential risks.

Main Requirements

- 1.2.22** R **A *firm* must at all times maintain overall financial resources, including capital and liquidity resources, which are adequate, both as to amount and quality, to ensure that there is no significant risk that its liabilities cannot be met as they fall due.**

- 1.2.23** G For this purpose, liabilities include contingent and prospective liabilities that a *firm* has potentially incurred. It therefore excludes liabilities that might arise from transactions that a *firm* has not entered into and which it could avoid, for example by ceasing to trade. It includes liabilities or costs that arise as a consequence of strategies other than continuing as a going concern. It also includes claims that could be made against a *firm*, which ought to be paid in accordance with fair treatment of *customers*, even if such claims could not be legally enforced.
- 1.2.24** G A *firm* should therefore make its assessment of adequate financial resources on realistic valuation bases for assets and liabilities taking into account the actual amounts and timing of cash flows under realistic adverse projections. This does not require a *firm* to hold financial resources sufficient to ensure that any particular margin of financial resources is maintained under such adverse projections.
- 1.2.25** G Risks may be addressed through holding capital to absorb losses that unexpectedly materialise. The ability to pay liabilities as they fall due also requires liquidity. Therefore, in assessing the adequacy of a *firm's* financial resources, both capital and liquidity needs should be considered. A *firm* should also consider the quality of its financial resources such as the loss-absorbency of different types of capital and the time required to liquidate different types of asset.
- 1.2.26** R **A *firm* must carry out regular assessments of the adequacy of its financial resources using processes and systems required by PRU 1.2.27R.**
- 1.2.27** R **The processes and systems referred to in PRU 1.2.26R must be proportionate to the nature, scale and complexity of the *firm's* activities.**
- 1.2.28** G PRU 1.2.27R amplifies the requirement in SYSC 3.2.6R.
- 1.2.29** G The processes and systems are required for a *firm's* internal assessment of the adequacy of its financial resources. The appropriateness of the internal process, and the degree of involvement of senior management in the process, will be taken into account by the FSA when reviewing a *firm's* assessment as part of the FSA's own assessment of the adequacy of a *firm's* financial resources. The processes and systems should ensure that the assessment of the adequacy of a *firm's* financial resources is reported to its senior management as often as is necessary. In addition, a *firm* would be expected to reassess the adequacy of its financial resources should the *firm* experience some material change to the nature or scale of its activities.
- 1.2.30** G The assessments undertaken by *firms in run-off* may not need to be as comprehensive or frequent compared to a *firm* not in run off since this may better reflect the reduced nature and complexity of its business and reduced access to new capital. Whilst a *firm in run-off* will still need to carefully monitor the progress of the run off, a more comprehensive assessment may only be appropriate on commencement of the run off or when considering a reduction in capital through the payment of a dividend or other capital distribution or if the *firm's* circumstances change materially.
- 1.2.31** R **The processes and systems required by PRU 1.2.26R must enable the *firm* to identify the major sources of risk to its ability to meet its liabilities as they fall due, including the major sources of risk in each of the following categories:**
- (1) *credit risk*;**

- (2) *market risk*;
- (3) *liquidity risk*;
- (4) *operational risk*; and
- (5) *insurance risk*.

- 1.2.32 G *PRU 1.2.31R* refers to five risk categories, credit, market, liquidity, operational and insurance,
- (1) operational risk refers to the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events; and
 - (2) insurance risk refers to the inherent uncertainties as to the occurrence, amount and timing of insurance liabilities.
- 1.2.33 R **The processes and systems required by *PRU 1.2.26R* must enable the *firm* to carry out an assessment of how it intends to deal with each of the major sources of risk identified in accordance with *PRU 1.2.31R*.**
- 1.2.34 G Certain risks such as systems and controls weaknesses may not be adequately addressed by, for example, holding additional capital and a more appropriate response would be to rectify the weakness. In such circumstances, the amount of financial resources required to address these risks, which may not be adequately addressed by holding additional capital, will be zero. However, a *firm* must, in accordance with *PRU 1.2.37R*, document the approaches taken to manage these risks.
- 1.2.35 R **For each of the major sources of risk identified in accordance with *PRU 1.2.31R*, the *firm* must carry out stress tests and scenario analyses that are appropriate to the nature of those major sources of risk, as part of which the *firm* must:**
- (1) **take reasonable steps to identify an appropriate range of realistic adverse circumstances and events in which the risk identified crystallises; and**
 - (2) **estimate the financial resources the *firm* would need in each of the circumstances and events considered in order to be able to meet its liabilities as they fall due.**
- 1.2.36 G Stress tests and scenario analyses should be carried out at least annually. A *firm* should, however, consider whether the nature of the major sources of risks identified by it in accordance with *PRU 1.2.31R* and their possible impact on its financial resources suggest that such tests and analyses should be carried out more frequently. For instance, a sudden change in the economic outlook may prompt a *firm* to revise the parameters of some of its stress tests and scenario analyses. Similarly, if a *firm* has recently become exposed to a particular sectoral concentration, it may wish to add some stress tests and scenario analyses in order to reflect that concentration.
- 1.2.37 R **A *firm* must make a written record of its assessment of the adequacy of its financial resources, including:**

- (1) the major sources of risk identified in accordance with *PRU 1.2.31R*;
- (2) how it intends to deal with those risks; and
- (3) details of the stress tests and scenario analyses carried out and the resulting financial resources estimated to be required in accordance with *PRU 1.2.35R*.

1.2.38 R A firm must retain the records of its assessment of the adequacy of its financial resources for at least 3 years.

1.2.39 G Where a *firm* follows the *guidance* set out in *PRU 2.3.35G* to *PRU 2.3.48G* and assesses the adequacy of the *capital resources requirement (CRR)* in its particular circumstances as a basis for deciding what financial resources are adequate, then it should include this in the documentation produced in accordance with *PRU 1.2.37R*.

Stress tests and scenario analyses

1.2.40 G A large part of the process of managing a *firm* is based on an understanding of the expected outcomes of its business operations and outside events and the normal variation about these expected outcomes. To gain a comprehensive view of the risks being run by a *firm* an analysis of extreme events is also needed. Such analysis may take the form of stress tests and scenario analyses. For example, a *firm* may normally expect interest rates to increase or decrease by 1 or 2 percentage points due to normal variations in economic conditions. However, in some extreme circumstances, interest rates may change by a much greater amount. The use of stress tests and scenario analyses can give a *firm's* management a better understanding of the *firm's* true exposure in extreme circumstances.

1.2.41 G Stress testing typically refers to shifting the values of individual parameters that affect the financial position of a *firm* and determining the effect on the *firm's* business.

1.2.42 G Scenario analysis typically refers to a wider range of parameters being varied at the same time. Scenario analyses often examine the impact of catastrophic events on the *firm's* financial position, for example, simultaneous movements in a number of risk categories affecting all of a *firm's* business operations such as business volumes, investment values and interest rate movements.

1.2.43 G Scenarios generally could also be considered under three broad categories. For example, changes to the business plan, scenarios that involve changes in business cycles and those relating to extreme events. The scenarios can be derived in a variety of ways including stochastic models, analysis of historic experience or a repetition of an historical event. Scenarios can be developed with varying degrees of precision and depth.

1.2.44 G Both stress tests and scenario analyses can be undertaken by *firms* to further a better understanding of the vulnerabilities that they face under extreme conditions. They are based on the analysis of the impact of unlikely, but not impossible, events. These events can be financial, operational, legal or relate to any other risk that might have an economic impact on the *firm*.

1.2.45 G *PRU 1.2.35R* requires a *firm*, as part of carrying out stress tests and scenario analyses, to take reasonable steps to identify an appropriate range of realistic circumstances and events in which a risk would crystallise. In particular:

- (1) *firms* need only carry out stress tests and scenario analyses in so far as the circumstances or events are reasonably foreseeable, that is to say, their occurrence is not too remote a possibility; and

- (2) *firms* should also take into account the relative costs and benefits of carrying out the stress tests and scenario analyses in respect of the circumstances and events identified.

- 1.2.46** G The purpose of stress tests and scenario analyses is to test the adequacy of overall financial resources. Scenarios need only be identified, and their impact assessed, in so far as this facilitates that purpose. In particular, the nature, depth and detail of the analysis depend, in part, upon the *firm's* capital strength and the robustness of its risk prevention and risk mitigation measures.
- 1.2.47** G Both stress testing and scenario analyses are prospective analysis techniques, which seek to anticipate possible losses that might occur if an identified risk crystallises. In applying them a *firm* needs to decide how far forward to look. This should depend upon:
- (1) how quickly it would be able to identify events or changes in circumstances that might lead to a risk crystallising resulting in a loss; and
 - (2) after it has identified the event or circumstance, how quickly and effectively it could act to prevent or mitigate any loss resulting from the risk crystallising and to reduce exposure to any further adverse event or change in circumstance.
- 1.2.48** G The time horizon over which stress tests and scenario analysis would need to be carried out for the *market risk* arising from the holding of investments, for example, should depend upon:
- (1) the extent to which there is a regular, open and transparent market in those assets, which would allow fluctuations in the value of the investment to be more readily and quickly identified; and
 - (2) the extent to which the market in those assets is liquid (and would remain liquid in the changed circumstances contemplated in the stress test or scenario analysis) which would allow the *firm*, if needed, to sell its holding so as to prevent or reduce exposure to future price fluctuations.
- 1.2.49** G In identifying scenarios, and assessing their impact, a *firm* should take into account, where material, how changes in circumstances might impact upon:
- (1) the nature, scale and mix of its future activities; and
 - (2) the behaviour of counterparties, and of the *firm* itself, including the exercise of choices (for example, *options* embedded in financial instruments or *contracts of insurance*).
- 1.2.50** G In determining whether it would have adequate financial resources in the event of each identified realistic adverse scenario a *firm* should:
- (1) only include financial resources that could reasonably be relied upon as being available in the circumstances of the identified scenario; and
 - (2) take account of any legal or other restriction on the purposes for which financial resources may be used.
- 1.2.51** G *Firms* should consider conducting stress tests and scenario analyses which enable them to assess their exposure not only in their current position in the economic and business cycles, but also the possible changes in the cycles which might be expected over, say, the next three to five years.

PRU 1.2 Adequacy of financial resources

- 1.2.52** G *Firms* may consider scenarios in which expected future profits will provide capital reserves against future risks. However, it would only be appropriate to take into account profits that can be foreseen with some certainty as arising before the risk against which they are being held could possibly arise. In estimating future reserves, *firms* should deduct future dividend payment estimates from projections of future profits.
- 1.2.53** G *Firms* may substitute for traditional stress tests and scenario analyses more sophisticated modelling techniques and this approach is acceptable providing major risks are identified and the modelling has the effect of calculating the effect on a *firm's* financial position where the risks crystallise or are assumed to crystallise with a particular probability.
- 1.2.54** G Additional *guidance* on stress tests and scenario analyses for the assessment of *capital resources* is available in *PRU 2.3*.
- 1.2.55** G Additional *guidance* in relation to stress tests and scenario analysis for *liquidity risk* is available in *PRU 5.1.54G* to *PRU 5.1.58G*.

1.3 VALUATION

Application

1.3.1R *PRU 1.3 applies to insurers, referred to as firms in this section.*

1.3.2R *PRU 1.3 does not apply to a firm which is:-*

- (1) *a non-directive friendly society;*
- (2) *an incoming EEA firm; or*
- (3) *an incoming Treaty firm.*

1.3.3G The scope of application of PRU 1.3 is not restricted to *firms* that are subject to the relevant EC directives. It applies, for example, to *pure reinsurers*.

- 1.3.4R
- (1) *PRU 1.3 applies to a firm in relation to the whole of its business.*
 - (2) *Where a firm carries on both long-term insurance business and general insurance business, PRU 1.3 applies separately to each type of business.*

Purpose

1.3.5G *PRU 1.3 sets out, for the purposes of PRU, rules and guidance as to how a firm should recognise and value assets, liabilities, equity and income statement items. It applies, unless the contrary is expressly stated, whenever a rule in PRU refers to the value or amount of an asset, liability, equity or income statement item.*

General requirements: accounting principles to be applied

1.3.6R *Except where the contrary is expressly stated in PRU, whenever a rule in PRU refers to an asset, liability, equity or income statement item, a firm must, for the purpose of that rule, recognise the asset, liability, equity or income statement item and measure its value in accordance with:*

- (1) *Schedule 9A to the Companies Act 1985, Schedule 9A to the Companies Act (Northern Ireland) Order 1986 or the Friendly Societies (Accounts and Related Provisions) Regulations 1994;*
- (2) *Financial Reporting Standards and Statements of Standard Accounting Practice issued or adopted by the Accounting Standards Board; and*
- (3) *Statements of Recommended Practice adopted by the Accounting Standards Board;*

as applicable to the *firm* (or as would be applicable if the *firm* was a company with its head office in the United Kingdom).

- 1.3.7G PRU 1.3.6 R provides that unless the contrary is expressly stated in *PRU*, the applicable provisions of the Companies Act 1985, the Companies Act (Northern Ireland) Order 1996 or the Friendly Societies (Accounts and Related Provisions) Regulations 1994, as supplemented by Financial Reporting Standards, Statements of Standard Accounting Practice, and Statements of Recommended Accounting Practice issued or adopted by the Accounting Standards Board, should be used to determine the recognition and valuation of assets, liabilities, equity and income statement items for the purposes of *PRU*, including:
- (1) whether, and when, to recognise or de-recognise an asset or liability;
 - (2) the amount at which to value an asset, liability, equity or income statement item;
 - (3) which description to place on an asset, liability, equity or income statement item.
- 1.3.8G In particular, unless an exception applies, PRU 1.3.6 R should be applied for the purposes of *PRU* to determine how to account for:
- (1) netting of amounts due to or from the *firm*;
 - (2) the securitisation of assets and liabilities (see also PRU 1.3.9G);
 - (3) leased tangible assets;
 - (4) assets transferred or received under a *sale and repurchase* or *stock lending* transaction; and
 - (5) assets transferred or received by way of initial or variation margin under a *derivative* or similar transaction.
- 1.3.9G Where assets or liabilities are securitised, PRU 1.3.6R only permits de-recognition where Financial Reporting Standard 5 permits either de-recognition or the linked presentation. However, the FSA will consider granting a *waiver* to permit de-recognition in other circumstances provided that the *firm* can demonstrate that securitisation has effectively transferred risk.
- 1.3.10G Specific provisions for the methods and assumptions to be used by a *firm* in calculating its *mathematical reserves* are made in PRU 7.3.
- 1.3.11G PRU 1.3.6R implements the requirements of Articles 23.3(viii) and 24.2(iv) of the *Life Assurance Directive*. These articles require assets of a *firm* that are managed by a *subsidiary undertaking* to be taken into account for the purposes

of determining the *firm's admissible assets* and its assets in excess of concentration limits. The application of PRU 1.3.6R will result in such assets remaining on the balance sheet of the *firm*.

Investments, *derivatives* and *quasi-derivatives*

1.3.12R Subject to PRU 1.3.32R, for the purposes of *PRU*, a *firm* must apply PRU 1.3.13 R to PRU 1.3.31 R in order to determine how to account for:-

- (1)** Investments that are, or amounts due arising from the disposal of:-
 - (a)** *debt securities*, bonds and other money- and capital-market instruments;
 - (b)** loans;
 - (c)** *shares* and other variable yield participations; or
 - (d)** *units in undertakings* for collective investment in transferable securities and other investment funds.
- (2)** *Derivatives* and *quasi-derivatives*.

MARKING TO MARKET

1.3.13R Wherever possible, a *firm* must use mark to market in order to measure the value of the investments referred to in PRU 1.3.12 R. Marking to market is valuation at readily available close out prices from independent sources.

1.3.14G For the purposes of PRU 1.3.13R, examples of readily available close out prices include exchange prices, screen prices, or quotes from several independent reputable brokers.

1.3.15R When marking to market, a *firm* must use the more prudent side of bid/offer price unless the *firm* is a significant market maker in a particular position type and it can close out at the mid-market price.

MARKING TO MODEL

1.3.16R Where marking to market is not possible, a *firm* must use mark to model in order to measure the value of the investments referred to in PRU 1.3.12R. Marking to model is any valuation which has to be benchmarked, extrapolated or otherwise calculated from a market input.

1.3.17R When the model used is developed by the *firm*, that model must be:-

- (1) based on appropriate assumptions which have been assessed and challenged by suitably qualified parties independent of the development process; and
- (2) independently tested, including validation of the mathematics, assumptions, and software implementation.

1.3.18R A *firm* must ensure that its senior management are aware of the positions which are subject to mark to model and understand the materiality of the uncertainty this creates in the reporting of the performance of the business of the *firm* and the risks to which it is subject.

1.3.19R A *firm* must source market inputs in line with market prices so far as possible and assess the appropriateness of the market inputs for the position being valued and the parameters of the model on each valuation date.

1.3.20R A *firm* must use generally accepted valuation methodologies for particular products where these are available.

1.3.21R A *firm* must establish formal change control procedures, hold a secure copy of the model, and periodically use that model to check valuations.

1.3.22R A *firm* must ensure that its risk management functions are aware of the weakness of the models used and how best to reflect those in the valuation output.

1.3.23R A *firm* must periodically review the model to determine the accuracy of its performance.

1.3.24G Examples of periodical review are assessing the continued appropriateness of the assumptions and comparison of actual close out values to model inputs.

INDEPENDENT PRICE VERIFICATION

1.3.25R In addition to marking to market or marking to model, a *firm* must perform independent price verification. This is the process by which market prices or model inputs are regularly verified for accuracy and independence.

1.3.26G For independent price verification, where independent pricing sources are not available or pricing sources are more subjective, for example, only one available broker quote, prudent measures such as valuation adjustments may be appropriate.

VALUATION ADJUSTMENTS OR RESERVES

- 1.3.27R A *firm* must establish and maintain procedures for considering valuation adjustments or reserves. These procedures must be compliant with the prudential requirements set out in PRU 1.3.30R.
- 1.3.28R A *firm* using third-party valuations, or marking to model, must consider whether valuation adjustments are necessary.
- 1.3.29R A *firm* must consider the need for establishing reserves for less liquid positions and, on an ongoing basis, review their continued appropriateness in accordance with PRU 1.3.30R.
- 1.3.30R The prudential requirements referred to in PRU 1.3.27R and PRU 1.3.29R are:
- (1) a firm must consider the following adjustments or reserves: unearned credit spreads, close-out costs, operational risks, early termination, investing and funding costs, future administrative costs and, where appropriate, model risk; and
 - (2) a *firm* must consider several factors when determining whether a valuation reserve is necessary for less liquid items. These factors include the amount of time it would take to hedge out the position/risks within the position; the average and volatility of bid/offer spreads; the availability of market quotes (number and identity of market makers); and the average and volatility of trading volumes.
- 1.3.31R If the result of establishing adjustments or reserves under PRU 1.3.27R to PRU 1.3.30R is a valuation which differs from the fair value determined in accordance with Financial Reporting Standards issued or adopted by the Accounting Standards Board, a *firm* must reconcile the two valuations.

Shares in, and debts due from, related undertakings

- 1.3.32R PRU 1.3.12R does not apply to *shares in, and debts due from, a related undertaking* that is:
- (1) a *regulated related undertaking*;
 - (2) an *ancillary services undertaking*; or
 - (3) any other *subsidiary undertaking*, the *shares* of which a *firm* elects to value in accordance with PRU 1.3.35R.
- 1.3.33R Except where the contrary is expressly stated in PRU, whenever a rule in PRU refers to *shares held in, and debts due from, an undertaking in PRU*

1.3.32R (1) or *PRU 1.3.32R (3)*, a *firm* must value the *shares* held in accordance with *PRU 1.3.35R*.

1.3.34R In relation to *shares* in, and debts due from, an *undertaking* in *PRU 1.3.32R (1)*, *PRU 1.3.33R* does not apply for the purposes of *PRU 2.2.78R* and *PRU 8.3*.

1.3.35R For the purposes of *PRU 1.3.33R*, the value of the *shares* held in an *undertaking* referred to in *PRU 1.3.32R (1)* or *PRU 1.3.32R (3)* is the sum of:

- (1) the *regulatory surplus value* of that *undertaking*; less
- (2) for the purposes of *PRU 2.2.90R*, the book value of the total investments in the *tier one capital resources* and *tier two capital resources* of that *undertaking* by the *firm* and its *related undertakings*; or
- (3) for other purposes in *PRU*, the sum of:
 - (a) the book value of the investments by the *firm* and its *related undertakings* in the *tier two capital resources* of the *undertaking*; and
 - (b) if the *undertaking* is an *insurance undertaking*, its *non-transferable capital*.

1.3.36R For the purposes of *PRU 1.3.35R (1)*, the *regulatory surplus value* of an *undertaking* in *PRU 1.3.32R (1)* or *PRU 1.3.32R (3)* is, subject to *PRU 1.3.37R*, the sum of:

- (1) the *tier one capital resources* of the *undertaking*; plus
- (2) the *tier two capital resources* of the *undertaking*; less
- (3) the *individual capital resources requirement* of the *undertaking*.

1.3.37R (1) For the purposes of *PRU 1.3.36R*, only the relevant proportion of the:

- (a) *tier one capital resources* of the *undertaking*;
- (b) *tier two capital resources* of the *undertaking*;
- (c) *individual capital resources requirement* of the *undertaking*;

is to be taken into account, subject to *PRU 1.3.38R*.

- (2) In (1), the relevant proportion is the proportion of the total number of *shares* in issue of the *undertaking* held, directly or indirectly, by the *firm*.

1.3.38R If the *individual capital resources requirement* of an *undertaking* in *PRU 1.3.32R (1)* that is a *subsidiary undertaking* exceeds the sum of its *tier one capital resources* and *tier two capital resources*, then the full amount of the items *PRU 1.3.37R (1)* shall be taken into account for the purposes of *PRU 1.3.36R*.

1.3.39R For the purposes of *PRU 1.3.35R* to *PRU 1.3.38R*:

- (1)** in relation to an *undertaking* in *PRU 1.3.32R (1)*:
 - (a)** *individual capital resources requirement* has the meaning given by *PRU 8.3.29R*;
 - (b)** the following expressions shall be construed in accordance with *PRU 8.3.33R*:
 - (i)** *tier one capital resources*; and
 - (ii)** *tier two capital resources*;
 - (c)** *non-transferable capital* has the meaning given by *PRU 8.3.52R*;
- (2)** in relation to an *undertaking* in *PRU 1.3.32R (3)*, the following expressions shall be construed as if that *undertaking* were an *insurance holding company*:
 - (a)** *individual capital resources requirement*;
 - (b)** *tier one capital resources*; and
 - (c)** *tier two capital resources*.

1.3.40G *PRU 1.3.35R* to *PRU 1.3.39R* set out several different valuation bases for a *firm's shares* in *related undertakings*. The *regulatory surplus value* (defined in *PRU 1.3.36R*) measures the *related undertaking's* own capital surplus or deficit. This is used: (i) in *PRU 1.3.35R* as a basis for calculating the impact on the *firm's* position of its investments in *related undertakings*; and (ii) in *PRU 8.3* as a starting point for the calculation of *non-transferable capital*.

1.3.41G *PRU 1.3.35R* determines how, for the purposes of the solo capital adequacy calculation of a *firm*, that *firm's capital resources* and *admissible assets* should be adjusted to take into account its investments in *related undertakings*.

1.3.42G The *rules* that specify how, for the purposes of the adjusted solo capital calculation, a *firm* must incorporate its *related undertakings* into its *capital resources* and *capital resources requirement* are set out in *PRU 8.3*.

Community co-insurance operations: general insurance business

1.3.43R

Where a relevant insurer determines the amount of a liability in order to make provision for outstanding claims under a *community co-insurance operation*, then, if the *leading insurer* has informed the relevant insurer of the amount of the provision made by the *leading insurer* for such claims, the amount determined by the relevant insurer -

- (1) must be at least as great as the amount of the provision made by the *leading insurer*; or
- (2) in a case where it is not the practice in the United Kingdom to make such provision separately, must be sufficient, when all liabilities are taken into account, to include provision at least as great as that made by the *leading insurer* for such claims,

due regard being had in either case to the proportion of the risk covered by the relevant insurer and by the *leading insurer* respectively.

2.1 Calculation of capital resources requirements

Application

- 2.1.1 R This chapter applies to *insurers*, referred to as *firms* in this chapter.
- 2.1.2 R **PRU 2.1 does not apply to:**
- (1) a *non-directive friendly society*; or
 - (2) a *Swiss general insurer*; or
 - (3) an *EEA-deposit insurer*; or
 - (4) an *incoming EEA firm*; or
 - (5) an *incoming Treaty firm*.
- 2.1.3 G The scope of application of *PRU 2.1* is not restricted to *firms* that are subject to the relevant EC directives. It applies, for example, to *pure reinsurers*.
- 2.1.4 R (1) ***PRU 2.1* applies to a *firm* in relation to the whole of its business, except where a particular provision provides for a narrower scope.**
- (2) **Where a *firm* carries on both *long-term insurance business* and *general insurance business*, *PRU 2.1* applies separately to each type of business.**
- 2.1.5 G The adequacy of a *firm's capital resources* needs to be assessed in relation to all the activities of the *firm* and the risks to which they give rise.
- 2.1.6 G The requirements in *PRU 2.1* apply to a *firm* on a solo basis.

Purpose

- 2.1.7 G *Principle 4* requires a *firm* to maintain adequate financial resources. *PRU 2* sets out provisions that deal specifically with the adequacy of that part of a *firm's* financial resources that consists of *capital resources*. The adequacy of a *firm's capital resources* needs to be assessed both by the *firm* and the *FSA*. Through its *rules*, the *FSA* sets minimum *capital resources requirements* for *firms*. It also reviews a *firm's* own assessment of its capital needs, and the processes and systems by which that assessment is made, in order to see if the minimum *capital resources requirements* are appropriate (see *PRU 2.3.2G* to *2.3.3G*).

PRU 2.1 Calculation of capital resources requirements

- 2.1.8 G This section (*PRU 2.1*) sets *capital resources requirements* for a *firm*. *PRU 2.2* sets out how, for the purpose of this, the amounts or values of capital, assets and liabilities are to be determined. More detailed *rules* relating to capital, assets and liabilities are also set out in the following chapters:
- PRU 3* Credit risk;
PRU 4 Market risk;
PRU 5 Liquidity risk;
PRU 6 Operational risk;
PRU 7 Insurance risk; and
PRU 8 Group risk.
- PRU 2.1* and *PRU 2.2* include appropriate cross-references to these modules.
- 2.1.9 G *PRU 2.1* implements minimum *EC* standards for the *capital resources* required to be held by a *firm* undertaking business that falls within the scope of the *Life Assurance Directive* (2002/83/EC) or the *First Non-Life Directive* (1973/239/EEC) as amended.

Main requirements

- 2.1.10 R **(1) Subject to (2), a *firm* must maintain at all times *capital resources* equal to or in excess of its *CRR*.**
- (2) A *firm* which is either an *insurance parent undertaking* or a *participating insurance undertaking* and, in relation to its own *group capital resources*, is in compliance with *PRU 8.3.13R(1)* is deemed to comply with this *rule*.**
- 2.1.11 R **A *firm* must comply with *PRU 2.1.10 R* separately in respect of both its *long-term insurance business* and its *general insurance business*.**
- 2.1.12 G In order to comply with *PRU 2.1.11 R*, a *firm* carrying on both *general insurance business* and *long-term insurance business* will need to allocate its *capital resources* between its *general insurance business* and *long-term insurance business* so that the *capital resources* allocated to its *general insurance business* are equal to or in excess of its *CRR* for its *general insurance business* and the *capital resources* allocated to its *long-term insurance business* are equal to or in excess of its *CRR* for its *long-term insurance business*. Whereas *long-term insurance assets* cannot be used towards meeting a *firm's CRR* for its *general insurance business*, surplus general insurance assets may be used towards meeting the *CRR* for its *long-term insurance business* (see *PRU 7.6.27R* to *7.6.29G*). *PRU 7.6* sets out the detailed requirements for the separation of *long-term* and *general insurance business*.
- 2.1.13 G *Firms* commonly use different terminology for the various *PRU* requirements. For example, the *MCR* is traditionally known as the required minimum margin.
- 2.1.14 G The *FSA* may impose a higher capital requirement than the minimum requirement set out in this section as part of the *firm's Part IV permission*. (See *PRU 2.3*).

Calculation of the CRR

PRU 2.1 Calculation of capital resources requirements

- 2.1.15** R The *CRR* for any *firm* carrying on *general insurance business* is equal to the *MCR* in *PRU 2.1.22 R*.
- 2.1.16** R The *CRR* for any *firm* to which this rule applies (see *PRU 2.1.17 R* and *PRU 2.1.18 R*) is the higher of:
- (1) the *MCR* in *PRU 2.1.23 R*; and
 - (2) the *ECR* in *PRU 2.1.35 R*.
- 2.1.17** R Subject to *PRU 2.1.18 R*, *PRU 2.1.16 R* applies to a *firm* carrying on *long-term insurance business*, other than:
- (1) a *non-directive mutual*;
 - (2) a *firm* which has no *with-profits insurance liabilities*; and
 - (3) a *firm* which has *with-profits insurance liabilities* that are, and at all times since the coming into force of *PRU 2.1.16 R* have remained, less than £500 million.
- 2.1.18** R *PRU 2.1.16 R* also applies to a *firm* of a type listed in *PRU 2.1.17R (3)* if:
- (1) the *firm* makes an election that *PRU 2.1.16 R* is to apply to it; and
 - (2) that election is made by written notice given to the *FSA* in a way that complies with the requirements for written notice in *SUP 15.7*.
- 2.1.19** G The effect of *PRU 2.1.17R(3)* is that a *firm* to which *PRU 2.1.16 R* applies because it has *with-profits insurance liabilities* of £500 million or more, will continue to be subject to *PRU 2.1.16 R* even if its *with-profits insurance liabilities* fall below £500 million. However, if that happens, it may apply for a *waiver* from *PRU 2.1.16 R* under section 148 of the *Act*. In exercising its discretion under section 148 of the *Act*, the *FSA* will have regard (among other factors) to whether there has been a material and permanent change to the *firm's* business and to the prospects of it continuing to have *with-profits insurance liabilities* of less than £500 million.
- 2.1.20** G A *firm* that has always had *with-profits insurance liabilities* of less than £500 million since *PRU 2.1.16 R* came into force may wish to “opt in” to *PRU 2.1.16 R* and therefore become a *realistic basis life firm*. By doing so, it becomes obliged to calculate a *with-profits insurance capital component* (see *PRU 2.1.35 R* and *PRU 7.4*), but it also becomes entitled to certain modifications to the way that a *firm* is required to calculate its *mathematical reserves* (see *PRU 7.3.48R* and *PRU 7.3.78R*). The *firm* is also then required to report its liabilities on a realistic basis (see *IPRU(INS) 9.31R(b)*). In order to “opt in”, the *firm* must make an election under *PRU 2.1.18 R* that *PRU 2.1.16 R* is to apply to it. If a *firm* that has elected to calculate and report its *with-profits insurance liabilities* on a realistic basis subsequently decides that it no longer wishes to do so, it may seek to “opt out” by applying for a *waiver* from *PRU 2.1.16 R* under section 148 of the *Act*. In exercising its discretion under section 148 of the *Act*, the *FSA* will have regard (among other factors) to whether there has been a material and permanent change to the *firm's* business and to whether it continues to have *with-profits insurance liabilities* of less than £500 million.

- 2.1.21 R The *CRR* for a *firm* carrying on *long-term insurance business*, but to which *PRU 2.1.16 R* does not apply, is equal to the *MCR* in *PRU 2.1.23 R*.

Calculation of the MCR

- 2.1.22 R For a *firm* carrying on *general insurance business* the *MCR* in respect of that business is the higher of:
- (1) the *base capital resources requirement* for *general insurance business* applicable to that *firm*; and
 - (2) the *general insurance capital requirement*.
- 2.1.23 R For a *firm* carrying on *long-term insurance business* the *MCR* in respect of that business is the higher of:
- (1) the *base capital resources requirement* for *long-term insurance business* applicable to that *firm*; and
 - (2) the sum of:
 - (a) the *long-term insurance capital requirement*; and
 - (b) the *resilience capital requirement*.
- 2.1.24 G The *MCR* gives effect to the EC directive minimum requirements. For *general insurance business*, the EC Directive minimum is the higher of the *general insurance capital requirement* and the relevant *base capital resources requirement*. For *long-term insurance business*, the EC directive minimum is the higher of the *long-term insurance capital requirement* and the *base capital resources requirement*. The *base capital resources requirement* is the minimum guarantee fund for the purposes of article 29(2) of the *Life Assurance Directive (2002/83/EC)* and article 17(2) of the *First Non-Life Directive (1973/239/EEC)* as amended. The *resilience capital requirement* is an FSA requirement that is additional to the EC minimum requirement for *long-term insurance business*.
- 2.1.25 G The calculation of the *resilience capital requirement* is set out in *PRU 4.2*.

Calculation of the base capital resources requirement

- 2.1.26 R The amount of a *firm's base capital resources requirement* is set out in Table 2.1.27 R.
- 2.1.27 R Table: Base capital resources requirement

Firm type	Amount: Currency equivalent of
General insurance business	

PRU 2.1 Calculation of capital resources requirements

	Liability insurer (classes 10-15)	Directive mutual	€2.25 million
		Non-directive insurer	€300,000
		Overseas firm	€1.5 million
		Other	€3 million
	Other insurer	Directive mutual	€1.5 million
		Non-directive insurer (classes 1 to 8, 16 or 18)	€225,000
		Non-directive insurer (classes 9 or 17)	€150,000
		Overseas firm	€1 million
		Other	€2 million
Long-term insurance business			
	Mutual	Directive	€2.25 million
		Non-directive	€600,000
	Overseas firm		€1.5 million
	Any other insurer		€3 million

- 2.1.28 R (1)** Subject to (2) and (3), the amount of the *base capital resources requirement* specified in the last column of the table in *PRU 2.1.27 R* for a *firm* which is not a *non-directive insurer* will increase each year, starting on the review date of 20 September 2005 (and annually after that), by the percentage change in the European index of consumer prices (comprising all EU member states, as published by Eurostat) from 20 March 2002, to the relevant review date, rounded up to a multiple of €100,000.
- (2)** In any year, if the percentage change since the last increase is less than 5%, then there will be no increase.
- (3)** The increase will take effect 30 days after the EU Commission has informed the European Parliament and Council of its review and the relevant percentage change.

PRU 2.1 Calculation of capital resources requirements

- 2.1.29** G Any increases in the *base capital resources requirement* referred to in PRU 2.1.28 R will be published on the FSA website.
- 2.1.30** R For the purposes of the *base capital resources requirement*, the exchange rate from the Euro to the pound sterling for each year beginning on 31 December is the rate applicable on the last day of the preceding October for which the exchange rates for the currencies of all the European Union member states were published in the Official Journal of the European Communities.

Calculation of the general insurance capital requirement

- 2.1.31** R A firm must calculate its *general insurance capital requirement* as the highest of:
- (1) the *premiums amount*;
 - (2) the *claims amount*; and
 - (3) the *brought forward amount*.
- 2.1.32** G The calculation of each of the *premiums amount*, *claims amount* and *brought forward amount* is set out in PRU 7.2.

Calculation of the long-term insurance capital requirement

- 2.1.33** R A firm must calculate its *long-term insurance capital requirement* as the sum of:
- (1) the *insurance death risk capital component*;
 - (2) the *insurance health risk capital component*;
 - (3) the *insurance expense risk capital component*; and
 - (4) the *insurance market risk capital component*.
- 2.1.34** G The calculation of each of the capital components is set out in PRU 7.2.

Calculation of the ECR

- 2.1.35** R For a firm carrying on *long-term insurance business* the ECR in respect of that business is the sum of:
- (1) the *long-term insurance capital requirement*;
 - (2) the *resilience capital requirement*; and
 - (3) the *with-profits insurance capital component*.

PRU 2.1 Calculation of capital resources requirements

- 2.1.36** G Details of the *resilience capital requirement* and the *with-profits insurance capital component* are set out in *PRU 4.2* and *PRU 7.4* respectively.

Monitoring requirements

- 2.1.37** R **A *firm* must at all times monitor whether it is complying with *PRU 2.1.10 R* and be able to demonstrate that it knows at all times whether it is complying with that *rule*.**
- 2.1.38** G For the purposes of *PRU 2.1.37 R*, a *firm* should have systems in place to enable it to be certain whether it has adequate *capital resources* to comply with *PRU 2.1.10 R* at all times. This does not necessarily mean that a *firm* needs to measure the precise amount of its *capital resources* and its *CRR* on a daily basis. A *firm* should, however, be able to demonstrate the adequacy of its *capital resources* at any particular time if asked to do so by the *FSA*.
- 2.1.39** R **A *firm* must notify the *FSA* immediately of any breach, or expected breach, of *PRU 2.1.10 R*.**

2.2 Capital resources

Application

2.2.1 R *PRU 2.2 applies to the firms to which PRU 2.1 applies.*

Purpose

- 2.2.2 G *PRU 2.1 sets out minimum capital resources requirements for a firm. This section (PRU 2.2) sets out how, for the purpose of these requirements, capital resources are defined and measured. PRU 2.2 also implements minimum EC standards for the composition of capital resources required to be held by a firm undertaking business that falls within the scope of the Life Assurance Directive (2002/83/EC) or the First Non-Life Directive (1973/239/EEC) as amended.*

Principles underlying the definition of capital resources

- 2.2.3 G The FSA has divided its definition of capital into categories, or tiers, reflecting differences in the extent to which the capital instruments concerned meet the purpose and conform to the characteristics of capital listed in PRU 2.2.5 G. The FSA generally prefers a firm to hold higher quality capital that meets the characteristics of permanency and loss absorbency that are features of *tier one capital*. Capital instruments falling into *core tier one capital* can be included in a firm's regulatory capital without limit. Typically, other forms of capital are either subject to limits (see PRU 2.2.16 R to PRU 2.2.26 R) or, in the case of some specialist types of capital, may only be included with the express consent of the FSA (which takes the form of a *waiver* under section 148 of the Act).
- 2.2.4 G Details of the individual components of capital are set out in Table PRU 2.2.14 R.

TIER ONE CAPITAL

- 2.2.5 G *Tier one capital* typically has the following characteristics:
- (1) it is able to absorb losses;
 - (2) it is permanent;
 - (3) it ranks for repayment upon winding up after all other debts and liabilities; and
 - (4) it has no fixed costs, that is, there is no inescapable obligation to pay dividends or interest.
- 2.2.6 G The forms of capital that qualify for *tier one capital* are set out in Table PRU 2.2.14 R and include, for example, *share* capital, reserves, verified interim net profits and, for a *mutual*, the *initial fund* plus permanent members' accounts. *Tier one capital* is divided into *core tier one capital*, perpetual non-cumulative *preference shares*, and *innovative tier one capital*.

UPPER AND LOWER TIER TWO CAPITAL

- 2.2.7 G *Tier two capital* includes forms of capital that do not meet the requirements for permanency and absence of fixed servicing costs that apply to *tier one capital*. *Tier two capital* includes, for example:

PRU 2.2 Capital resources

- (1) capital which is perpetual (that is, has no fixed term) but cumulative (that is, servicing costs cannot be waived at the issuer's option, although they may be deferred – for example cumulative *preference shares*). Perpetual capital instruments may be included in *upper tier two capital*; and
- (2) capital which is not perpetual (that is, it has a fixed term) and which may also have fixed servicing costs that cannot generally be either waived or deferred, for example subordinated debt. Such capital should normally be of a medium to long-term maturity (that is, an original maturity of at least five years). Dated capital instruments are included in *lower tier two capital*.

DEDUCTIONS FROM CAPITAL

- 2.2.8 G Deductions should be made at the relevant stage of the calculation of *capital resources* to reflect capital that may not be available to the *firm* or assets of uncertain value, for example, holdings of intangible assets and assets that are inadmissible for a *firm*.
- 2.2.9 G A full list of deductions from *capital resources* is shown in Table PRU 2.2.14 R.

Calculation of capital resources

- 2.2.10 G *Capital resources* can be calculated either as the total of eligible assets less foreseeable liabilities (which is the approach taken in the *Insurance Directives*) or by identifying the components of capital. Both calculations give the same result for the total amount of *capital resources*. The approach taken in this section has been to specify the components of capital and the relevant deductions. This is set out in Table PRU 2.2.14 R. This approach is the same as that used for the calculation of *capital resources* for *banks*, *building societies* and *investment firms*. A simple example, showing the reconciliation of the two methods, is given in Table PRU 2.2.11 G.
- 2.2.11 G Table: Approaches to calculating *capital resources*

Liabilities		Assets	
Borrowings	100	Admissible assets	350
Ordinary <i>shares</i>	200	Intangible assets	100
Profit and loss account and other reserves	100	Other inadmissible assets	100
Perpetual subordinated debt	150		
Total	<u>550</u>	Total	<u>550</u>

Calculation of <i>capital resources</i> : eligible assets less foreseeable liabilities	
Total assets	550
less intangible assets	(100)
less inadmissible assets	(100)
less liabilities (borrowings)	(100)
<i>Capital resources</i>	<u>250</u>

Calculation of <i>capital resources</i> : components of capital	
Ordinary <i>shares</i>	200
Profit and loss account and other reserves	100
Perpetual subordinated debt	150
less intangible assets	(100)
less inadmissible assets	(100)
<i>Capital resources</i>	<u>250</u>

2.2.12 R A *firm* must calculate its capital resources for the purpose of *PRU* in accordance with Table *PRU* 2.2.14 R, subject to the limits in *PRU* 2.2.16 R to *PRU* 2.2.26 R.

2.2.13 G Where Table *PRU* 2.2.14 R refers to related text, it is necessary to refer to that text in order to understand fully what is included in the descriptions of capital items and deductions set out in the table.

2.2.14 R Table: Capital resources (see *PRU* 2.2.12 R)

Related text		Included in the calculation of capital resources
		A ✓ denotes that the item is included in the calculation of a <i>firm's capital resources</i> ; a ✗ denotes that the item is not included in the calculation of a <i>firm's capital resources</i> .
(A) CORE TIER ONE CAPITAL:		
<i>Permanent share capital</i>	<i>PRU</i> 2.2.36 R	✓
Profit and loss account and other reserves	<i>PRU</i> 2.2.76 R	✓
<i>Share</i> premium account	None	✓
Externally verified interim net profits	<i>PRU</i> 2.2.82 R	✓
Positive valuation differences	<i>PRU</i> 2.2.78 R	✓
Fund for future appropriations	None	✓
(B) PERPETUAL NON-CUMULATIVE PREFERENCE SHARES		
Perpetual non-cumulative <i>preference shares</i>	<i>PRU</i> 2.2.50 R	✓
(C) INNOVATIVE TIER ONE CAPITAL:		

PRU 2.2 Capital resources

	Related text	Included in the calculation of capital resources
<i>Innovative tier one instruments</i>	PRU 2.2.52 R to 2.2.75 R	✓
(D) TOTAL TIER ONE CAPITAL BEFORE DEDUCTIONS = A + B + C		
(E) DEDUCTIONS FROM TIER ONE CAPITAL:		
Investments in own <i>shares</i>	None	✓
Intangible assets	PRU 2.2.84 R	✓
Amounts deducted from <i>technical provisions</i> for discounting and other negative valuation differences	PRU 2.2.78 R to 2.2.79 G	✓
(F) TOTAL TIER ONE CAPITAL AFTER DEDUCTIONS = D – E		
(G) UPPER TIER TWO CAPITAL:		
Perpetual cumulative <i>preference shares</i>	PRU 2.2.101 R	✓
Perpetual subordinated debt	PRU 2.2.101 R	✓
Perpetual subordinated securities	PRU 2.2.101 R	✓
(H) LOWER TIER TWO CAPITAL		
Fixed term <i>preference shares</i>	None	✓
Fixed term subordinated debt	PRU 2.2.108 R	✓
Fixed term subordinated securities	PRU 2.2.108 R	✓
(I) TOTAL TIER TWO CAPITAL = G + H		
(J) POSITIVE ADJUSTMENTS FOR RELATED UNDERTAKINGS		
<i>Related undertakings</i> that are <i>regulated related undertakings</i> (other than <i>insurance undertakings</i>)	PRU 2.2.90R	✓
(K) TOTAL CAPITAL AFTER POSITIVE ADJUSTMENTS FOR INSURANCE UNDERTAKINGS BUT BEFORE DEDUCTIONS = F + I + J		
(L) DEDUCTIONS FROM TOTAL CAPITAL		
Inadmissible assets	PRU 2.2.86 R & Annex 1R	✓
Assets in excess of market and counterparty limits	PRU 3.2.25R	✓
<i>Related undertakings</i> that are <i>ancillary services undertakings</i>	PRU 2.2.89R	✓

	Related text	Included in the calculation of capital resources
Negative adjustments for <i>related undertakings</i> that are <i>regulated related undertakings</i> (other than <i>insurance undertakings</i>)	<i>PRU</i> 2.2.90R	✓
(M) TOTAL CAPITAL AFTER DEDUCTIONS (K – L)		
(N) OTHER CAPITAL RESOURCES*:		
Unpaid <i>share</i> capital or, in the case of a <i>mutual</i> , <i>unpaid initial funds</i> and calls for supplementary contributions	<i>PRU</i> 2.2.126 G to <i>PRU</i> 2.2.128 G	×
<i>Implicit items</i>	<i>PRU</i> 2.2 Annex 2G	×
(O) TOTAL CAPITAL RESOURCES AFTER DEDUCTIONS = M + N		
* Items in section (N) of the table can be included in <i>capital resources</i> if subject to a <i>waiver</i> under section 148 of the <i>Act</i> .		

Limits on the use of different forms of capital

- 2.2.15 G As the various components of capital differ in the degree of protection that they offer the *firm* and its *consumers*, restrictions are placed on the extent to which certain types of capital are eligible for inclusion in a *firm's capital resources*. These restrictions are set out in *PRU* 2.2.16 R to *PRU* 2.2.26 R.
- 2.2.16 R At least 50% of a *firm's MCR* must be accounted for by the sum of:
- (1) the amount calculated at stage A of the calculation in *PRU* 2.2.14 R; and
 - (2) notwithstanding *PRU* 2.2.20 R(1), the amount calculated at stage B of the calculation in *PRU* 2.2.14 R;
- less the amount calculated at stage E of the calculation in *PRU* 2.2.14 R.
- 2.2.17 R A *firm* carrying on *long-term insurance business* must meet the higher of:
- (1) 1/3 of the *long-term insurance capital requirement*; and
 - (2) the *base capital resources requirement*,
- with the sum of the items listed at stages A, B, G and H less the sum of the items listed at stage E in *PRU* 2.2.14 R.

- 2.2.18 R A firm carrying on general insurance business must meet the higher of:**
- (1) 1/3 of the general insurance capital requirement; and**
 - (2) the base capital resources requirement,**
- with the sum of the items listed at stages A, B, G and H less the sum of the items listed at stage E in PRU 2.2.14 R.**
- 2.2.19 G** The purposes of the requirements in PRU 2.2.16 R to 2.2.18 R are to comply with the *Insurance Directives*' requirement that firms maintain a *guarantee fund* of higher quality capital resources items and to ensure that at least 50% of the firm's capital resources needed to meet its MCR provide maximum loss absorbency to protect the firm from insolvency.
- 2.2.20 R In relation to a firm's tier one capital resources calculated at stage F of the calculation in PRU 2.2.14 R:**
- (1) at least 50% must be accounted for by core tier one capital; and**
 - (2) no more than 15% may be accounted for by innovative tier one capital.**
- 2.2.21 G** The purpose of the requirement in PRU 2.2.20 R(1) is to ensure that at least 50% of the firm's tier one capital resources (net of tier one capital deductions) is met by core tier one capital which provides maximum loss absorbency on a going concern basis to protect the firm from insolvency. Although a perpetual non-cumulative preference share is in legal form a share, it behaves in many ways like a perpetual fixed interest debt instrument. Within the 50% limit on non-core tier one capital, PRU 2.2.20 R (2) places a further sub-limit on the amount of innovative tier one capital that a firm may include in its tier one capital resources. This limit is necessary to ensure that most of a firm's tier one capital comprises items of capital of the highest quality.
- 2.2.22 G** The amount of any capital item excluded from a firm's tier one capital resources under PRU 2.2.20 R may form part of its tier two capital resources subject to the limits in PRU 2.2.23 R.
- 2.2.23 R Subject to PRU 2.2.24 R, a firm must exclude from the calculation of its capital resources the following:**
- (1) the amount (if any) by which tier two capital resources exceed the amount calculated at stage F of the calculation in PRU 2.2.14 R; and**
 - (2) the amount (if any) by which lower tier two capital resources exceed 50% of the amount calculated at stage F of the calculation in PRU 2.2.14 R.**
- 2.2.24 R At least 75% of a firm's MCR must be accounted for by the sum of:**
- (1) the amount calculated at stage A plus stage B less stage E of the calculation in PRU 2.2.14 R; and**

- (2) the amount calculated at stage G of the calculation in *PRU 2.2.14 R*.

- 2.2.25 G *PRU 2.2.23 R* and *PRU 2.2.24 R* give effect to the *Insurance Directives'* requirements that a firm's tier two capital resources must not exceed its tier one capital resources and that no more than 25% of a firm's "required solvency margin" should consist of lower tier two capital resources.
- 2.2.26 R A firm that carries on both *long-term insurance business* and *general insurance business* must apply the limits in *PRU 2.2.16 R* to *2.2.24 R* separately for each type of business.

CHARACTERISTICS OF TIER ONE CAPITAL

- 2.2.27 R A firm may not include a share in, or another investment in, or external contribution to the capital of, that firm in its tier one capital resources unless it complies with the following conditions:
- (1) it is included in one of the categories in *PRU 2.2.28 R*;
 - (2) it is not excluded by any of the rules in *PRU 2.2*; and
 - (3) it complies with the conditions set out in *PRU 2.2.29 R*.
- 2.2.28 R The categories referred to in *PRU 2.2.27 R*(1) are:
- (1) *permanent share capital*;
 - (2) a perpetual non-cumulative *preference share*; and
 - (3) an *innovative tier one instrument*.
- 2.2.29 R Subject to *PRU 2.2.30 R*, an item of capital in a firm complies with *PRU 2.2.27 R* (3) if:
- (1) it is issued by the firm;
 - (2) it is fully paid and the proceeds of issue are immediately and fully available to the firm;
 - (3) it:
 - (a) cannot be redeemed at all or can only be redeemed on a winding up of the firm; or
 - (b) complies with the conditions in *PRU 2.2.38 R* and *PRU 2.2.39 R*;
 - (4) any coupon is either non-cumulative or, if it is cumulative, it complies with *PRU 2.2.40 R*;

- (5) it is able to absorb losses to allow the *firm* to continue trading and in the case of an *innovative tier one instrument* it complies with *PRU 2.2.56 R* to *PRU 2.2.58 R*;
- (6) it ranks for repayment upon winding up no higher than a *share* of a company incorporated under the Companies Act 1985 or the Companies (Northern Ireland) Order 1986 (whether or not it is such a *share*);
- (7) the *firm* has the right to choose whether or not to pay a *coupon* on it in cash at any time;
- (8) the description of its characteristics used in its marketing is consistent with the characteristics required to satisfy *PRU 2.2.29 (1)* to (7)R.

- 2.2.30 R (1) An item of capital does not comply with *PRU 2.2.27 R(3)* if the issue of that item of capital by the *firm* is connected with one or more other transactions which, when taken together with the issue of that item, could produce the effect described in (2).
- (2) The effect referred to in (1) is a reduction in the economic benefit intended to be conferred on the *firm* by the issue of the item of capital in a manner which means that the item of capital no longer displays all of the characteristics set out in *PRU 2.2.29 R(1)* to (8).
- 2.2.31 R An item of capital does not comply with *PRU 2.2.29 R(5)* if the holder of that item does not bear losses to at least the same degree as the holder of a *share* of a company incorporated under the Companies Act 1985 or the Companies (Northern Ireland) Order 1986 (whether or not it is such a *share*).
- 2.2.32 G *PRU 2.2.29 R(2)* is stricter than the Companies Act definition of fully paid, which only requires an undertaking to pay.
- 2.2.33 G An item of capital does not comply with *PRU 2.2.29 R(8)* if it is marketed as a capital instrument that would only qualify for a lower level of capital or on the basis that investing in it is like investing in a *lower tier two instrument*. For example, an undated capital instrument should not be marketed as a dated capital instrument if the terms of the capital instrument include an option by the issuer to redeem the capital instrument at a specified date in the future.
- 2.2.34 G For the purposes of *PRU 2.2.30 R*, examples of connected transactions might include guarantees or any other side agreement provided to the holders of the capital instrument by the *firm* or a connected party or a related transaction designed, for example, to enhance their security or to achieve a tax benefit, but which may compromise the loss absorption capacity or permanence of the original capital item.
- 2.2.35 R A *firm* may not include a *share* in its *tier one capital resources* unless (in addition to complying with the other relevant *rules* in *PRU 2.2*):

- (1) (in the case of a *firm* that is a company as defined in the Companies Act 1985 or the Companies (Northern Ireland) Order 1986) it is “called-up *share capital*” within the meaning given to that term in that Act or, as the case may be, that Order; or
- (2) (in the case of any other *firm*) it is:
 - (a) in economic terms; and
 - (b) in its characteristics as capital (including loss absorbency, permanency, ranking for repayment and fixed costs);
 substantially the same as called-up *share capital* falling into (1).

CORE TIER ONE CAPITAL: PERMANENT SHARE CAPITAL

2.2.36 R *Permanent share capital* means an item of capital which (in addition to satisfying PRU 2.2.29 R) meets the following conditions:

- (1) it is:
 - (a) an ordinary *share*; or
 - (b) a *members' contribution*; or
 - (c) part of the *initial fund* of a *mutual*;
- (2) any *coupon* on it is not cumulative, and the *firm* has both the right to choose whether or not to pay a *coupon* and the right to choose the amount of that *coupon*; and
- (3) the terms upon which it is issued do not permit redemption and it is otherwise incapable of being redeemed to at least the degree of an ordinary *share* issued by a company incorporated under the Companies Act 1985 or the Companies (Northern Ireland) Order 1986 (whether or not it is such a *share*).

2.2.37 G PRU 2.2.36 R has the effect that the *firm* should be under no obligation to make any payment in respect of a *tier one instrument* if it is to form part of its *permanent share capital* unless and until the *firm* is wound up. A *tier one instrument* that forms part of *permanent share capital* could not therefore count as a liability before the *firm* is wound up. The fact that relevant company law permits the *firm* to make earlier repayment does not mean that the *tier one instruments* are not eligible. However, the *firm* should not be required by any contractual or other obligation arising out of the terms of that capital to repay *permanent share capital*. Similarly a *tier one instrument* may still qualify if company law allows dividends to be paid on this capital, provided the *firm* is not contractually or otherwise obliged to pay them. There should therefore be no fixed costs.

BASIC RULES ABOUT REDEMPTION AND CUMULATIVE COUPONS

2.2.38 R In relation to a perpetual non-cumulative *preference share* which is redeemable, a *firm* may not include it in its *tier one capital resources*, unless its contractual terms are such that:

- (a) it is redeemable only at the option of the *firm*; and
- (b) the *firm* cannot exercise that redemption right:
 - (i) on or before the fifth anniversary of its date of issue;
 - (ii) unless it has given notice to the *FSA* in accordance with *PRU 2.2.72 R*; and
 - (iii) unless at the time of exercise of that right it complies with *PRU 2.1.10R* and will continue to do so after redemption.

2.2.39 R In relation to an *innovative tier one instrument* which is redeemable and which, either:

- (a) is or may become subject to a *step-up*; or
- (b) satisfies *PRU 2.2.54 R(2)*;

a *firm* may not include it in its *tier one capital resources* unless it complies with the conditions in *PRU 2.2.38 R*, save that in *PRU 2.2.38 R(b)(i)*, "fifth anniversary" is replaced by "tenth anniversary".

2.2.40 R A *potential tier one instrument* with a cumulative *coupon* complies with *PRU 2.2.29 R(4)* only if any such *coupon* must, if deferred, be paid by the *firm* in the form of *permanent share capital*.

2.2.41 G *PRU 2.2.38 R* does not apply to *permanent share capital* because no item of capital that is either redeemable or that has a cumulative *coupon* can be *permanent share capital*.

FURTHER GUIDANCE ON REDEMPTION

2.2.42 G The *rules* in *PRU 2.2* about redemption of *potential tier one instruments* fall into three classes:

- (1) *rules* defining whether a *firm's potential tier one instruments* are eligible for inclusion in its *tier one capital resources* at all;
- (2) *rules* defining whether a *firm's potential tier one instruments* are eligible for inclusion in its *permanent share capital*; and
- (3) *rules* defining whether a *firm's potential tier one instruments* must be classified as *innovative tier one instruments*.

2.2.43 G The *rules* about redemption that are relevant to deciding whether a *firm's potential tier one instruments* are eligible for inclusion in its *tier one capital resources* at all are as follows.

- (1) *PRU 2.2.29 R(3)* and *PRU 2.2.39 R* have the following provisions.

PRU 2.2 Capital resources

- (a) Any capital instrument that is redeemable at the option of the holder cannot form part of a *firm's tier one capital resources*. Instead, if it is redeemable at all, a capital instrument should only be redeemable at the option of the *firm*.
 - (b) A redemption right should be exercisable no earlier than the fifth anniversary of the date of issue. However, if an instrument is an *innovative tier one instrument* which is subject to a *step-up* or any other economic incentive to redeem, any such redemption should be exercisable no earlier than the tenth anniversary.
 - (c) Any redemption proceeds should be payable only in cash or in *shares*.
 - (d) The terms of the capital instrument should provide that any redemption right should not be exercised unless and until the *firm* has given the notice to the FSA required under PRU 2.2.72 R.
 - (e) Any redemption right should not be exercisable unless both before and after the redemption the *firm* complies with PRU 2.1.10R (which requires that a *firm* has sufficient *capital resources* to meet its *capital resources requirement*).
- (2) Under PRU 2.2.70 R, a *firm* should not include a *potential tier one instrument* that is redeemable in whole or in part in *permanent share capital* in its *tier one capital resources* unless the *firm* has:
- (a) sufficient *permanent share capital* or sufficient authority to issue *permanent share capital* (and the authority to allot it) to meet any redemption obligations that have become due; and
 - (b) a prudent reserve of *permanent share capital* or sufficient authority to issue *permanent share capital* (and the authority to allot it) to meet possible future redemption obligations.
- (3) PRU 2.2.65 R contains limits on the amount of *permanent share capital* that may be issued on a redemption of a *potential tier one instrument* redeemable in *permanent share capital*.

2.2.44 G The *rules* defining whether a *firm's potential tier one instruments* are eligible for inclusion in its *permanent share capital* are to be found in PRU 2.2.36 R. As far as redemption is concerned, it says that the capital instrument should be no more capable of being redeemed than a *share* under the Companies Act 1985 or the Companies (Northern Ireland) Order 1986. PRU 2.2.38 R (which sets out the basic rules for redemption) does not apply to *permanent share capital* as a redeemable *potential tier one instrument* should not be included in *permanent share capital*.

2.2.45 G The *rules* about redemption that are relevant to deciding whether a *firm's potential tier one instruments* should be classified as *innovative tier one instruments* are as follows.

- (1) Under PRU 2.2.53 R, a redeemable *potential tier one instrument* is always treated as an *innovative tier one instrument* if the redemption proceeds are payable otherwise than in cash.
- (2) Under PRU 2.2.54 R, any feature of a *tier one instrument* that in conjunction with a call would make a *firm* more likely to redeem it or to have an incentive to do so will make it an *innovative tier one instrument*.
- (3) Under PRU 2.2.62 R a *step-up* coupled with a right of redemption results in a *potential tier one instrument* being treated as an *innovative tier one instrument*.

FURTHER GUIDANCE ON COUPONS

PRU 2.2 Capital resources

- 2.2.46 G The *rules* in PRU 2.2 about the *coupons* payable on *potential tier one instruments* fall into the same three classes that apply to the *rules* on redemption, as set out in PRU 2.2.42 G.
- 2.2.47 G The *rules* about *coupons* that are relevant to deciding whether a *firm's potential tier one instruments* are eligible for inclusion in its *tier one capital resources* at all are as follows.
- (1) Under PRU 2.2.29 R(4) and PRU 2.2.40 R, any deferred cumulative *coupon* should only be payable in *permanent share capital*. If a cumulative *coupon* is payable on a *potential tier one instrument* in another form, it should not be included in the *firm's tier one capital resources*.
 - (2) Under PRU 2.2.29 R(7), the *firm* has the right not to pay a *coupon* in cash at any time.
 - (3) PRU 2.2.63 R says that a *potential tier one instrument* that may be subject to a *step-up* that potentially exceeds defined limits should not be included in the *firm's tier one capital resources*. PRU 2.2.64 R says that any *step-up* should not arise before the tenth anniversary of the date of issue if it is to be included in the *firm's tier one capital resources*.
 - (4) The provisions of PRU 2.2.70 R summarised in PRU 2.2.43 G(2) also apply to the payment of *coupons*.
- 2.2.48 G PRU 2.2.36 R(2) says that a capital instrument on which a cumulative *coupon* is payable must not be included in a *firm's permanent share capital*. The payment of a *coupon* should be purely discretionary.
- 2.2.49 G The *rules* about *coupons* that are relevant to deciding whether a *firm's potential tier one instruments* should be classified as *innovative tier one instruments* are as follows:
- (1) Under PRU 2.2.60 R a *potential tier one instrument* with a cumulative *coupon* is an *innovative tier one instrument*.
 - (2) Under PRU 2.2.60 R(2) a *potential tier one instrument* with a *coupon* that if deferred must be paid in *permanent share capital* is an *innovative tier one instrument*.
 - (3) Under PRU 2.2.62 R a *step-up* coupled with a right by the *firm* of redemption results in a *potential tier one instrument* being treated as an *innovative tier one instrument*.

PERPETUAL NON-CUMULATIVE PREFERENCE SHARES

- 2.2.50 R A perpetual non-cumulative *preference share* may be included at stage B of the calculation in PRU 2.2.14 R if:
- (1) it complies with PRU 2.2.29 R, PRU 2.2.35 R and PRU 2.2.38 R(b)(i);
 - (2) any *coupon* on it is not cumulative, and the *firm* has the right to choose whether or not to pay a *coupon*;
 - (3) it is not excluded from *tier one capital resources* by any of the *rules* in PRU 2.2; and
 - (4) it is not an *innovative tier one instrument*.

- 2.2.51 G Perpetual non-cumulative *preference shares* should be perpetual and redeemable only at the *firm's* option. These *shares* are normally classified as equity on a *firm's* balance sheet. Perpetual *preference shares* may be non-cash cumulative or non-cumulative if the *shares* are to be included in *tier one capital*. Any feature that, in conjunction with a call, would make a *firm* more likely to redeem perpetual non-cumulative *preference shares* would normally result in classification as an *innovative tier one instrument*. Such features would include, but not be limited to, a *step-up*, bonus *coupon* on redemption or redemption at a premium to the original issue price of the *share*.

INNOVATIVE TIER ONE INSTRUMENTS: GENERAL RULES

- 2.2.52 R If an item of capital is stated to be an *innovative tier one instrument* by the rules in PRU 2.2, it cannot be included in stages A or B of the calculation in PRU 2.2.14 R.
- 2.2.53 R If a *tier one instrument* is redeemable at the option of the *firm*, it is an *innovative tier one instrument* unless it is redeemable solely in cash.
- 2.2.54 R If a *tier one instrument*:
- (1) is redeemable; and
 - (2) is issued on terms that are (or its terms are amended and the amended terms are) such that a reasonable *person* would (judging at or around the time of issue or amendment) think that:
 - (a) the *firm* is likely to redeem it; or
 - (b) the *firm* is likely to have a substantial economic incentive to redeem it;

that *tier one instrument* is an *innovative tier one instrument*.

- 2.2.55 G Any feature that in conjunction with a call, would make a *firm* more likely to redeem a *tier one instrument* would normally result in classification as *innovative tier one capital resources*. *Innovative tier one instruments* include but are not limited to those incorporating a *step-up* or principal stock settlement.

INNOVATIVE TIER ONE INSTRUMENTS: LOSS ABSORBENCY

- 2.2.56 R A capital instrument may only be included in *innovative tier one capital resources* if a *firm's* obligations under the instrument either:
- (1) do not constitute a liability (actual, contingent or prospective) under section 123(2) of the Insolvency Act 1986; or
 - (2) do constitute such a liability but the terms of the instrument are such that:
 - (a) any such liability is not relevant for the purposes of deciding whether;
 - (i) the *firm* is, or is likely to become, unable to pay its

debts; or

(ii) its liabilities exceed its assets;

(b) a creditor (including, but not limited to, a holder of the instrument) is not able to petition for the winding up or administration of the *firm* on the grounds that the *firm* is or may become unable to pay any such liability; and

(c) the *firm* is not obliged to take into account such a liability for the purposes of deciding whether or not the *firm* is, or may become, insolvent for the purposes of section 214 of the Insolvency Act 1986 (wrongful trading).

2.2.57 G The effect of PRU 2.2.56 R is that if a *potential tier one instrument* does constitute a liability, this should only be the case when the *firm* is able to pay that liability but chooses not to do so. As *tier one capital resources* must be undated, this will generally only be relevant on a solvent winding up of the *firm*.

2.2.58 R A *firm* wishing to issue an *innovative tier one instrument* must obtain an opinion from Queen's Counsel, or where the opinion relates to the law of a jurisdiction outside the *United Kingdom*, from a lawyer in that jurisdiction of equivalent status, confirming that the criteria in PRU 2.2.29 R(5) and PRU 2.2.31 R are met.

2.2.59 G The holder should agree that the *firm* has no liability (including any contingent or prospective liability) to pay any amount to the extent to which that liability would cause the *firm* to become insolvent if it made the payment or to the extent that its liabilities exceed its assets or would do if the payment were made. The terms of the capital instrument should be such that the directors can continue to trade in the best interests of the senior creditors even if this prejudices the interests of the holders of the instrument.

INNOVATIVE TIER ONE INSTRUMENTS: COUPONS

2.2.60 R A *tier one instrument* with a cumulative coupon which complies with PRU 2.2.40 R is an *innovative tier one instrument*.

2.2.61 G An item of capital does not fall into PRU 2.2.60 R merely because a *firm* has come under an obligation to pay a particular coupon in *permanent share capital* where that obligation is the result of a voluntary election by the holder or the *firm* to be paid the coupon in that form. Thus, for example, if a shareholder of a *firm* is allowed to elect to be paid a dividend in the form of a conventional scrip dividend, that does not make the *share* into an *innovative tier one instrument*.

INNOVATIVE TIER ONE INSTRUMENTS AND OTHER TIER ONE INSTRUMENTS: STEP-UPS

2.2.62 R If:

(1) a *potential tier one instrument* is or may become subject to a *step-up*; and

(2) that *potential tier one instrument* is redeemable at any time (whether before, at or after the time of the *step-up*);

that *potential tier one instrument* is an *innovative tier one instrument*.

- 2.2.63 R If a *potential tier one instrument* is or may become subject to a *step-up*, a *firm* must not include it in its *tier one capital resources* if the amount of the *step-up* exceeds or may exceed;

(1) 100 basis points; and

(2) 50% of the *initial credit spread*.

- 2.2.64 R A *firm* must not include a *potential tier one instrument* that is or may become subject to a *step-up* in its *tier one capital resources* if the *step-up* can arise earlier than the tenth anniversary of the date of issue of that item of capital.

INNOVATIVE TIER ONE INSTRUMENTS: PRINCIPAL STOCK SETTLEMENT

- 2.2.65 R A *firm* must not include a *potential tier one instrument* that is redeemable in whole or in part in *permanent share capital* in its *tier one capital resources* if:

(1) the conversion ratio as at the date of redemption may be greater than the conversion ratio as at the time of issue by more than 200%; or

(2) the issue or market price of the conversion instruments issued in relation to one unit of the original capital item (plus any cash element of the redemption) may be greater than the issue price (or, as the case may be, market price) of that original capital item.

- 2.2.66 R In *PRU 2.2.65 R* to *PRU 2.2.69 R*:

(1) the original capital item means the capital item that is being redeemed; and

(2) the conversion instrument means the *permanent share capital* issued on its redemption.

- 2.2.67 R In *PRU 2.2.65 R* to *PRU 2.2.69 R*, the conversion ratio means the ratio of:

(1) the number of units of the conversion instrument that the *firm* must issue to satisfy its redemption obligation (so far as it is to be satisfied by the issue of conversion instruments) in respect of one unit of the original capital item; to

(2) one unit of the original capital item.

- 2.2.68 R In *PRU 2.2.65 R*, the conversion ratio as at the date of issue of the original capital item is calculated as if the original capital item were redeemable at that time.

- 2.2.69 R** If the conversion instruments or the original capital item are subdivided or consolidated or subject to any other occurrence that would otherwise result in like not being compared with like, the conversion ratio calculation in *PRU 2.2.65 R* must be adjusted accordingly.

REQUIREMENT TO HAVE SUFFICIENT UNISSUED STOCK

- 2.2.70 R** (1) This *rule* applies to a *potential tier one instrument* of a *firm* where either:
- (a) the redemption proceeds; or
 - (b) any *coupon* on that capital item;
- can be satisfied by the issue of another *tier one instrument*.
- (2) A *firm* may only include an item of capital to which this *rule* applies in its *tier one capital resources* if the *firm* has authorised and unissued *tier one instruments* of the kind in question (and the authority to issue them):
- (a) that are sufficient to satisfy all such payments then due; and
 - (b) are of such amount as is prudent in respect of such payments that could become due in the future.

NOTIFYING THE FSA OF THE ISSUE AND REDEMPTION OF TIER ONE INSTRUMENTS

- 2.2.71 R** A *firm* must not include any perpetual non-cumulative *preference shares* or *innovative tier one instruments* in its *tier one capital resources* for the purpose of *PRU 2.2* unless it has notified the *FSA* of its intention at least one month before it first includes them.
- 2.2.72 R** A *firm* must not redeem any *tier one instrument* that it has included in its *tier one capital resources* for the purpose of *PRU 2.2* unless it has notified the *FSA* of its intention at least one month before it does so.

NON STANDARD CAPITAL INSTRUMENTS

- 2.2.73 G** There may be examples of capital instruments that, although based on a standard form, contain structural features that make the rules in *PRU 2.2* difficult to apply. In such circumstances, a *firm* may seek individual *guidance* on the application of those *rules* to the capital instrument in question. See *SUP 9* for the process to be followed when seeking individual *guidance*.

STEP-UPS

- 2.2.74 R** In relation to a *tier one instrument*, a *step-up* means any change in the *coupon* rate on that instrument that results in an increase in the amount payable at any time, including a change already provided in the original terms governing those payments. A *step-up*:

- (1) includes (in the case of a fixed rate) an increase in that *coupon* rate;
- (2) includes (in the case of a floating rate calculated by adding a fixed amount to a fluctuating amount) an increase in that fixed amount;
- (3) includes (in the case of a floating rate) a change in the identity of the benchmark by reference to which the fluctuating element of the *coupon* is calculated that results in an increase in the absolute amount of the *coupon*;
- (4) does not include (in the case of a floating rate) an increase in the absolute amount of the *coupon* caused by fluctuations in the fluctuating figure by reference to which the absolute amount of the *coupon* floats.

- 2.2.75 R Where a *rule* in *PRU 2.2* says that a particular treatment applies to an item of capital that is subject to a *step-up* of a specified amount, the question of whether that *rule* is satisfied must be judged by reference to the cumulative amount of all *step-ups* since the issue of that item of capital rather than just by reference to a particular *step-up*.

PROFIT AND LOSS ACCOUNT AND OTHER RESERVES

- 2.2.76 R Negative amounts, including any interim net losses, must be deducted from *tier one capital resources*.
- 2.2.77 R Dividends must be deducted from reserves as soon as they are declared.

VALUATION DIFFERENCES

- 2.2.78 R Valuation differences are all differences between the valuation of assets and liabilities as valued in *PRU* and the valuation that the *firm* uses for its external financial reporting purposes, except valuation differences which are dealt with elsewhere in *PRU 2.2.14 R*. The sum of these valuation differences must either be added to (if positive) or deducted from (if negative) a *firm's capital resources*.
- 2.2.79 G Additions to and deductions from *capital resources* will arise from the application of asset and liability valuation and admissibility *rules* (see *PRU 1.3*, *PRU 2.2.86 R* and *PRU 2.2 Annex 1R*). Downward adjustments include discounting of *technical provisions* for *general insurance business* (which is optional for financial reporting but not permitted for regulatory valuation – see *PRU 2.2.80 R* to *PRU 2.2.81 R*). Details of valuation differences relating to *technical provisions* and liability adjustments for *long-term insurance business* are set out in *PRU 7.3*.

- 2.2.80 R** *PRU 2.2.81 R applies to a firm that carries on general insurance business, except a pure reinsurer, and which discounts or reduces its technical provisions for claims outstanding to take account of its investment income as permitted by Article 60(1g) of Council Directive 91/674/EEC of 19 December 1991 on the annual accounts and consolidated accounts of insurance undertakings.*
- 2.2.81 R** *A firm of a kind referred to in PRU 2.2.80 R must deduct from its capital resources the difference between the undiscounted technical provisions or technical provisions before deductions as disclosed in the notes on the accounts, and the discounted technical provisions or technical provisions after deductions. This adjustment must be made for all general insurance business classes, except for risks listed under classes 1 and 2. For classes other than 1 and 2, no adjustment needs to be made in respect of the discounting of annuities included in technical provisions.*

EXTERNALLY VERIFIED INTERIM NET PROFITS

- 2.2.82 R** *Externally verified interim net profits are interim profits verified by a firm's external auditors after deduction of tax, anticipated dividends and other appropriations that have been verified.*
- 2.2.83 G** *The FSA may request a firm to provide it with a copy of the external auditor's opinion on whether the interim profits are fairly stated.*

INTANGIBLE ASSETS

- 2.2.84 R** *A firm must deduct from its tier one capital resources the value of intangible assets.*
- 2.2.85 G** *Intangible assets include goodwill, capitalised development costs, brand names, trademarks and similar rights, and licences.*

INADMISSIBLE ASSETS

- 2.2.86 R** *For the purposes of PRU 2.2.14 R, a firm must deduct from total capital resources the value of any asset which is not an admissible asset as listed in PRU 2.2 Annex 1R.*
- 2.2.87 G** *PRU 2.2.86 R does not apply to intangible assets which must be deducted from tier one capital resources under PRU 2.2.84 R.*
- 2.2.88 G** *The list of admissible assets has been drawn with the aim of excluding assets:*
- (1) for which a sufficiently objective and verifiable basis of valuation does not exist; or*
 - (2) whose realisability cannot be relied upon with sufficient confidence; or*
 - (3) whose nature presents an unacceptable custody risk; or*
 - (4) the holding of which may give rise to significant liabilities or onerous duties.*

ADJUSTMENTS FOR RELATED UNDERTAKINGS

- 2.2.89 R** A *firm* must deduct from its *capital resources* the value of its investments in each of its *related undertakings* that is an *ancillary services undertaking*.
- 2.2.90 R** In relation to each of its *related undertakings* that is a *regulated related undertaking* (other than an *insurance undertaking*) a *firm* must add to (if positive), at stage J in *PRU 2.2.14 R*, or deduct from (if negative), at stage L in *PRU 2.2.14 R*, its *capital resources* the value of its *shares* in that undertaking calculated in accordance with *PRU 1.3.35R*.
- 2.2.91 G** For the purposes of *PRU 2.2.89 R*, investments must be valued at their accounting book value in accordance with *PRU 1.3.6R*.
- 2.2.92 G** *Related undertakings* which are also *insurance undertakings* are not included in *PRU 2.2.90 R* because a *firm* that is an *insurance parent undertaking* or a *participating insurance undertaking* is subject to the requirements of *PRU 8.3*.

ADDITIONAL REQUIREMENTS FOR A TIER ONE OR TIER TWO INSTRUMENT ISSUED BY A FIRM CARRYING ON WITH-PROFITS INSURANCE BUSINESS

- 2.2.93 R** A *firm* carrying on *with-profits insurance business* must, in addition to the other requirements in respect of *capital resources* elsewhere in *PRU 2.2*, meet the following conditions before a capital instrument can be included in the *firm's capital resources*:
- (1) the *firm* must manage the *with-profits fund* so that discretionary benefits under a *with-profits insurance contract* are calculated and paid disregarding, insofar as is necessary for its *customers* to be treated fairly, any liability the *firm* may have to make payments under the capital instrument;
 - (2) the intention to manage the *with-profits fund* on the basis set out in *PRU 2.2.93 R(1)* must be disclosed in the *firm's Principles and Practices of Financial Management*; and
 - (3) no amounts, whether interest, principal, or other amounts must be payable by the *firm* under the capital instrument if the *firm's* assets would then be insufficient to enable it to declare and pay under a *with-profits insurance contract* discretionary benefits that are consistent with the *firm's* obligations under *PRIN 6*.

PRU 2.2 Capital resources

- 2.2.94 G The purpose of *PRU 2.2.93 R* is to achieve practical subordination of capital instruments if they are to qualify as *capital resources* to the liabilities a *firm* has to *with-profits policyholders*, including liabilities which arise from the regulatory duty to treat customers fairly in setting discretionary benefits. (*Principle 6* (Customers' interests) requires a *firm* to pay due regard to the interests of its *customers* and treat them fairly.) It is not sufficient for a capital instrument to be subordinated to such liabilities only on winding up of the *firm* because such liabilities to *policyholders* may have been reduced by the inappropriate use of management discretion to enable funds to be applied in repaying subordinated capital instruments before winding up proceedings commence.
- 2.2.95 G *PRU 2.2.93 R* is an additional requirement to all other rules in *PRU 2.2* concerning the eligibility of a capital instrument to count as a component of a *firm's capital resources*. Subordinated debt instruments will be the main type of capital instrument to which this *rule* is relevant, including both *upper tier two* (undated) and *lower tier two* (dated) subordinated debt instruments. Subordinated debt instruments which are issued by a related *group undertaking* are not intended to be covered by this *rule* and may be included in *group capital resources* as appropriate if the other eligibility criteria are met.
- 2.2.96 G *PRU 2.2.29 R(8)* and *PRU 2.2.108 R(11)* contain provisions concerning the marketing of a capital instrument. In relation to a *firm* to which *PRU 2.2.93 R* applies, in order to comply with *PRU 2.2.29 R (8)* and *PRU 2.2.108 R(11)*, it should draw to the attention of subscribers the risk that payments may be deferred or cancelled in order to operate the *with-profits fund* so as to give priority to the payment of discretionary benefits to *with-profits policyholders*.
- 2.2.97 G (1) *Upper tier two instruments* must meet the requirements of *PRU 2.2.101 R (3)* which goes beyond the requirement in *PRU 2.2.93 R (3)* since it requires a *firm* to have the option to defer payments in all circumstances, not just if necessary to treat *customers* fairly. However, for *lower tier two instruments*, *PRU 2.2.93 R (3)* represents an additional requirement since a failure to pay amounts of interest or principal on a due date must not constitute an event of default under *PRU 2.2.108 R (2)* for *firms* carrying on *with-profits insurance business*.
- (2) For *firms* which are *realistic basis life firms* compliance with *PRU 2.2.93 R (3)* would usually be achieved if the capital instrument provides that no amounts will be payable under it unless the *firm's capital resources* exceed its *capital resources requirement*. However, such *firms* should ensure that the terms of the capital instrument refer to *FSA* capital resources requirements in force from time to time, including the current realistic reserving requirements and are not restricted to former minimum capital requirements based only on the *Insurance Directives'* required minimum margin of solvency. For *firms* which are not *realistic basis life firms*, compliance with *PRU 2.2.93 R (3)* will probably require specific reference to be made to treating *customers* fairly in the terms of the capital instrument.

TIER TWO CAPITAL

- 2.2.98 G *Tier two capital resources* is split into upper and lower tiers. The principal distinction between *upper* and *lower tier two capital* is that perpetual instruments may be included in *upper tier two capital* whereas dated instruments, such as fixed term *preference shares* and dated subordinated debt, are included in *lower tier two capital*.
- 2.2.99 G *Tier two capital instruments* are capital instruments that combine the features of debt and equity in that they are structured like debt, but exhibit some of the loss absorption and funding flexibility features of equity.

UPPER TIER TWO CAPITAL

- 2.2.100 G Examples of capital instruments which may be eligible to count in *upper tier two capital resources* include the following:
- (1) perpetual cumulative *preference shares*;
 - (2) perpetual subordinated debt; and
 - (3) other instruments that have the same economic characteristics as (1) or (2).
- 2.2.101 R **A capital instrument must meet the following conditions before it can be included in a *firm's upper tier two capital resources*:**
- (1) it must meet the general conditions described in *PRU 2.2.108 R*;
 - (2) it must have no fixed maturity date;
 - (3) the contractual terms of the instrument must provide for the *firm* to have the option to defer any interest payment on the debt; and
 - (4) the contractual terms of the instrument must provide for the loss-absorption capacity of the debt and unpaid interest, whilst enabling the *firm* to continue its business.
- 2.2.102 R **A capital instrument does not meet *PRU 2.2.101 R*(4) unless it meets *PRU 2.2.103 R* and *PRU 2.2.105 R*.**
- 2.2.103 R **A capital instrument may only be included in *upper tier two capital resources* if a *firm's* obligations under the instrument either:**
- (1) do not constitute a liability (actual, contingent or prospective) under section 123(2) of the Insolvency Act 1986; or
 - (2) do constitute such a liability but the terms of the instrument are such that:
 - (a) any such liability is not relevant for the purposes of deciding whether:
 - (i) the *firm* is, or is likely to become, unable to pay its debts; or
 - (ii) its liabilities exceed its assets;
 - (b) a creditor (including but not limited to a holder of the instrument) is not able to petition for the winding up or administration of the *firm* on the grounds that the *firm* is or may become unable to pay any such liability; and
 - (c) the *firm* is not obliged to take into account such a liability for the purposes of deciding whether or not the *firm* is, or may become, insolvent for the purposes of section 214 of the Insolvency Act 1986 (wrongful trading).

- 2.2.104 G The effect of *PRU 2.2.103 R* is that if an *upper tier two instrument* does constitute a liability, this should only be the case when the *firm* is able to pay that liability but chooses not to do so. As *upper tier two capital resources* must be undated, this will generally only be relevant on a solvent winding up of the *firm*.
- 2.2.105 R **A *firm* wishing to issue an *upper tier two capital instrument* other than a perpetual cumulative *preference share* must obtain an opinion from Queen’s Counsel, or where the opinion relates to the law of a jurisdiction outside the *United Kingdom*, from a lawyer in that jurisdiction of equivalent status, confirming that the criteria in *PRU 2.2.101 R(4)* are met.**
- 2.2.106 G For the purpose of *PRU 2.2.103 R(2)(b)* above, the holder should agree that the *firm* has no liability (including any contingent or prospective liability) to pay any amount to the extent to which that liability would cause the *firm* to become insolvent if it made the payment or to the extent that its liabilities exceed its assets or would do if the payment were made. The terms of the capital instrument should be such that the *directors* can continue to trade in the best interests of the senior creditors even if this prejudices the interests of the holders of the instrument.

LOWER TIER TWO CAPITAL

- 2.2.107 G Capital instruments that meet the general conditions described in *PRU 2.2.108 R* may be included in *lower tier two capital resources*.

GENERAL CONDITIONS FOR ELIGIBILITY AS TIER TWO CAPITAL

- 2.2.108 R **A capital instrument must not form part of the *tier two capital resources* of a *firm* unless it meets the following conditions:**
- (1) the claims of the creditors must rank behind those of all unsubordinated creditors;
 - (2) the only events of default must be non-payment of any amount falling due under the terms of the capital instrument or the winding-up of the *firm*;
 - (3) the remedies available to the subordinated creditor in the event of non-payment or other breach of the written agreement or instrument must be limited to petitioning for the winding up of the *firm* or proving for the debt and claiming in the liquidation of the *firm*;
 - (4) any events of default and any remedy described in (3) must not prejudice the matters in (1) and (2);
 - (5) in addition to the requirements about repayment in (1) and (2), the debt must not become due and payable before its stated final maturity date (if any) except on an event of default complying with (3);

- (6) the debt agreement or terms of the capital instrument are governed by the law of England and Wales, or of Scotland or of Northern Ireland;
- (7) to the fullest extent permitted under the laws of the relevant jurisdictions, creditors must waive their right to set off amounts they owe the *firm* against subordinated amounts included in the *firm's capital resources* owed to them by the *firm*;
- (8) the terms of the capital instrument must be set out in a written agreement that contains terms that provide for the conditions set out in (1) to (7);
- (9) the debt must be unsecured and fully paid up;
- (10) the description of its characteristics used in its marketing is consistent with the characteristics required to satisfy (1) to (9); and
- (11) the *firm* has obtained a properly reasoned external legal opinion stating that the requirements in (1) to (10) have been met.

- 2.2.109 G For the purposes of *PRU 2.2.108 R(5)* the debt agreement or terms of the instrument should not contain any clause which might require early repayment of the debt (e.g. cross default clauses, negative pledges and restrictive covenants). A cross default clause is a clause which says that the loan goes into default if any of the borrower's other loans go into default. It is intended to prevent one creditor being repaid before other creditors, e.g. obtaining full repayment through the courts. A negative pledge is a clause which puts the loan into default if the borrower gives any further charge over its assets. A restrictive covenant is a term of contract that directly, or indirectly, could lead to early repayment of the debt. Some covenants, e.g. relating to the provision of management information or ownership restrictions, are likely to comply with *PRU 2.2.108 (5)R* as long as monetary redress is ruled out, or any payments are covered by the subordination and limitation of remedies clauses (that is, if damages are unpaid, the only remedy is to petition for a winding up).
- 2.2.110 G The purpose of *PRU 2.2.108 R(7)* is to ensure that all of the *firm's* assets are available to *consumers* ahead of subordinated creditors. The waiver should apply both before and during a liquidation.
- 2.2.111 R ***PRU 2.2.108 R(6)* does not apply if the *firm* has obtained a properly reasoned external legal opinion confirming that the same degree of subordination has been achieved under the law that governs the debt and the agreement as that which would have been achieved under the laws of England and Wales, Scotland, or Northern Ireland.**
- 2.2.112 G An item of capital does not comply with *PRU 2.2.108 R(10)* if it is marketed as a capital instrument that would only qualify for a lower level of capital or on the basis that investing in it is like investing in a lower tier capital instrument. For example, an undated capital instrument should not be marketed as a dated capital instrument if the terms of the capital instrument include an option by the issuer to redeem the capital instrument at a specified date in the future.

- 2.2.113 R (1)** An item of capital does not comply with *PRU 2.2.101 R* or *PRU 2.2.108 R* if the issue of that item of capital by the *firm* is connected with one or more other transactions which, when taken together with the issue of that item, could produce the effect described in (2).
- (2)** The effect referred to in (1) is a reduction in the economic benefit intended to be conferred on the *firm* by the issue of the item of capital in a manner which means that the item of capital no longer displays all of the characteristics set out in *PRU 2.2.101 R* or *PRU 2.2.108 R*.
- 2.2.114 G** For the purposes of *PRU 2.2.113 R*, examples of connected transactions might include guarantees or any other side agreement provided to the holders of the capital instrument by the *firm* or a connected party or a related transaction designed, for example, to enhance their security or to achieve a tax benefit, but which may compromise the loss absorption capacity or permanence of the original capital item.
- 2.2.115 G** The *FSA* is more concerned that the subordination provisions listed in *PRU 2.2.108 R* should be effective than that they should follow a particular form. The *FSA* does not, therefore prescribe that the loan agreement should be drawn up in a standard form.
- 2.2.116 R** **A *firm* must not amend the terms of the debt and the documents referred to in *PRU 2.2.108 R*(8) unless:**
- (1)** at least one month before the amendment is due to take effect, the *firm* has given the *FSA* notice in writing of the proposed amendment and the *FSA* has not objected; and
- (2)** that notice includes confirmation that the legal opinions referred to in *PRU 2.2.108 R*(11) and, if applicable, *PRU 2.2.111 R* and *PRU 2.2.105 R* continue in full force and effect in relation to the terms of the debt and the documents as proposed to be so amended.
- 2.2.117 R** **A *firm* must notify the *FSA* of its intention to repay a *tier two instrument* at least six months before the date of the proposed repayment (unless the *firm* intends to repay an instrument on its contractual repayment date) providing details of how it will meet its *capital resources requirement* after such repayment.**

STEP-UPS

- 2.2.118 R** In relation to a *tier two instrument*, a *step-up* in a *coupon* rate means:
- (1)** (in the case of a fixed rate) an increase in that rate;
- (2)** (in any other case) any change in the way that the interest or other payment is calculated that may result in an increase in the amount payable at any time, including a change already provided in the original terms governing those payments.

- 2.2.119 R** Where a *tier two capital instrument* is subject to one or more *step-ups*, the first date that a *step-up* can take effect must be treated, for the purposes of this section, as the instrument's final maturity date if its actual maturity date occurs after that, unless the effect of the *step-up* or *step-ups* is to increase the *coupon* rate at which payments are to be made by no more than:
- (1) 50 basis points in the first ten years of the life of the debt; or
 - (2) 100 basis points over the whole life of the debt.
- 2.2.120 R** A *firm* may not include in its *tier two capital resources* a capital instrument the terms of which provide for a *step-up* in the first five years after issue.
- 2.2.121 R** Where a *step-up* arises through a change from paying a *coupon* on a debt instrument to paying a dividend on a share issued in settlement of the *coupon*, then any cost to the *firm* arising from the tax treatment of the dividend may be excluded.
- 2.2.122 G** Debt instruments containing embedded options, e.g. issues containing options for the interest rate after the *step-up* to be at a margin over the higher of two (or more) reference rates, or for the interest rate in the previous period to act as a floor, may affect the funding costs of the borrower and imply a *step-up*. In such circumstances a *firm* may wish to seek individual *guidance* on the application of the *rules* relating to *step-ups* to the capital instrument in question. See *SUP* 9 for the process to be followed when seeking individual *guidance*.

OTHER CONDITIONS FOR ELIGIBILITY AS LOWER TIER TWO CAPITAL

- 2.2.123 R** A capital instrument may be included in *lower tier two capital resources* only if it has an original maturity of at least five years or, where it has no fixed maturity date, notice of repayment of not less than five years has been given.
- 2.2.124 R** In its final four years to maturity, for the purposes of calculating the amount of a *lower tier two capital instrument* which may be included in a *firm's capital resources*, the principal amount must be amortised on a straight line basis by 20% per annum.
- 2.2.125 G** *PRU* 2.2.124 R applies both to a *tier two capital instrument* with a fixed maturity and to a *tier two instrument* with no fixed maturity but where the *firm* has given five year's notice of repayment.

UNPAID SHARE CAPITAL OR INITIAL FUNDS AND CALLS FOR SUPPLEMENTARY CONTRIBUTIONS

- 2.2.126 G** Unpaid *share* capital or, in the case of a *mutual*, unpaid *initial funds* and calls for supplementary contributions are excluded from the *capital resources* of a *firm* except to the extent allowed in a *waiver* under section 148 of the *Act*.

PRU 2.2 Capital resources

- 2.2.127 G Subject to a *waiver*, under the *Insurance Directives* a maximum of one half of unpaid *share* capital or, in the case of a *mutual*, one half of the *unpaid initial fund* may be included in a *firm's capital resources*, once the paid-up part amounts to 25% of that *share* capital or fund, up to 50% of total *capital resources*.
- 2.2.128 G In the case of a *mutual* carrying on *general insurance business* and subject to a *waiver*, calls for supplementary contributions within the *financial year* may only be included in a *firm's capital resources* up to a maximum of 50% of the difference between the maximum contributions and the contributions actually called in, subject to a limit of 50% of total *capital resources*. In the case of a *mutual* carrying on *long-term insurance business*, the *Life Assurance Directive* does not permit calls for supplementary contributions to be included in a *firm's capital resources*.

Annex 1R

Admissible assets in insurance funds

(1) **Investments**

- (a) *debt securities*, bonds and other money and capital market instruments; or
- (b) loans; or
- (c) *shares* and other variable yield participations; or
- (d) *units* in *undertakings* for collective *investment* in *transferable securities* and other *investment funds*; or
- (e) land, buildings and immovable property rights; or
- (f) an *approved derivative* or *quasi-derivative* transaction that satisfies the conditions in *PRU 4.3.6R* or an *approved stock lending* transaction that satisfies the conditions in *PRU 4.3.37R*.

(2) **Debts and claims**

- (a) debts owed by reinsurers, including reinsurers' shares of *technical provisions*; or
- (b) *deposits* with and debts owed by ceding *undertakings*; or
- (c) debts owed by *policyholders* and *intermediaries* arising out of direct and reinsurance operations (except where overdue for more than 3 months and other than *commission* prepaid to agents or *intermediaries* - see *PRU 3.2*); or
- (d) for *general insurance business* only, claims arising out of salvage and subrogation; or
- (e) for *long-term insurance business* only, advances secured on, and not exceeding the *surrender value* of, *long-term insurance contracts* issued by the *insurer*; or
- (f) tax recoveries; or
- (g) claims against *compensation funds*.

(3) **Other assets**

- (a) tangible fixed assets, other than land and buildings; or
- (b) cash at *bank* and in hand, *deposits* with *credit institutions* and any other bodies authorised to receive *deposits*; or
- (c) for *general insurance business* only, *deferred acquisition costs*; or
- (d) accrued interest and rent, other accrued income and prepayments; or
- (e) for *long-term insurance business* only, reversionary interests.

Annex 2G

Guidance on applications for waivers relating to implicit items

Implicit items under the Act

1. *PRU 2.2.14R* does not permit *implicit items* to be included in the calculation of a *firm's capital resources*, except subject to a waiver under section 148 of the *Act*. Article 27(4) of the *Life Assurance Directive* states that *implicit items* can be included in the calculation of a *firm's capital resources*, within limits, provided that the supervisory authority agrees. Certain *implicit items*, however, are not eligible for inclusion beyond 31 December 2009 (see paragraph 5). The *FSA* may be prepared to grant a *waiver* from *PRU 2.2.14 R* to allow *implicit items*, in line with the purpose of the *Life Assurance Directive*, and provided the conditions as set out in article 27(4) of the *Life Assurance Directive* are met. Such a *waiver* would allow an *implicit item* to count towards the *firm's capital resources* available to count against its *capital resources requirement (CRR)* set out for *realistic basis life firms* in *PRU 2.1.16R* and for *regulatory basis only life firms* in *PRU 2.1.21R*. Where a firm applies for an *implicit item waiver* the *firm* may also apply for a *waiver* from *PRU 2.2.16R*, which requires at least 50% of a *firm's MCR* to be covered by *core tier one capital* and perpetual non-cumulative *preference shares*. Under *PRU 2.2.17R* a firm must meet the *guarantee fund* from the sum of the items listed at stages A, B, G and H less the sum of the items listed at Stage E of *PRU 2.2.14R*. *PRU 2.2.17R* addresses the requirement in article 29(1) of the *Life Assurance Directive* that implicit items should be excluded from capital eligible to cover the *guarantee fund*. Where an *implicit items waiver* is granted, an *implicit item* may potentially count as either *tier one* or *tier two capital*, but not *core tier one capital*. *PRU 2.2.20R* requires that at least 50 % of a *firm's tier one capital resources* must be accounted for by *core tier one capital resources*.
2. Under section 148 of the *Act*, the *FSA* may, on the application of a *firm*, grant a *waiver* from *PRU*. There are general requirements that must be met before any *waiver* can be granted. As explained in *SUP 8*, the *FSA* may not give a *waiver* unless the *FSA* is satisfied that:
 - (1) compliance by the *firm* with the *rules* will be unduly burdensome, or would not achieve the purpose for which the *rules* were made; and
 - (2) the *waiver* would not result in undue risk to *persons* whose interests the *rules* are intended to protect.
3. The *FSA* will assess compliance with the requirements in the light of all the relevant circumstances. This will include consideration of the costs incurred by compliance with a particular *rule* or whether a *rule* is framed in a way that would make compliance difficult in view of the *firm's* circumstances. For example, the *firm* may demonstrate that if an *implicit item* were not allowed, the *firm* would either have to suffer increased (and unwarranted) costs in injecting further *capital resources* or operate with a lower equity backing ratio (see case studies in paragraph 43).
4. *Implicit items* are economic reserves which are contained within the *long-term insurance business* provisions. Article 27(4) of the *Life Assurance Directive* identifies three types of *implicit item*, in respect of: future profits, *zillmerisation* and hidden reserves. This annex is intended to amplify the guidance in *SUP 8* relating to the granting of *waivers* for *implicit items* and to provide guidance on other aspects. Whilst this guidance applies to applications for *waivers* for *implicit items* generally, for a *realistic basis life firm*, to the extent that an *implicit item* is allocated to a *with-profits fund*, this guidance relates to *implicit items* for the purposes of determining the *regulatory value of liabilities* (see *PRU 7.4.27R*).
5. The *Life Assurance Directive* (reflecting the changes introduced by the *Solvency 1 Directive*) requires member states to end a *firm's* ability to take into account future profits *implicit items*

by (at the latest) 31 December 2009. Until then, the maximum amount of the *implicit item* relating to future profits permitted under the *Life Assurance Directive* is limited to 50% of the product of the estimated annual profits and the average period to run (not exceeding six years) on the policies in the portfolio. The *Life Assurance Directive* further limits the maximum amount of these economic reserves that can be counted to 25% of the lesser of the available solvency margin and the required solvency margin. The changes introduced by the *Solvency 1 Directive* take effect for financial years beginning on or after 1 January 2004. However, the *Life Assurance Directive* allows for a transitional period of five years, which runs from 20 March 2002 (the publication date of the *Solvency 1 Directive*), for *firms* to become fully compliant with these new requirements. *Firms* will need to consider the potential impact of these changes when engaging in future capital planning. When applying for an *implicit item waiver* a firm should provide the FSA with a plan showing how the *firm* intends to maintain its capital adequacy over the period to 31 December 2009. *Firms* should also be aware that the FSA will typically only grant *waivers* for a maximum of 12 months.

Future Profits

6. The future profits *implicit item* allows *firms* to take credit for margins in the *mathematical reserves* to the extent that these are expected to emerge from in force business. The future profit from in force business should be assessed, in the first instance, on prudent assumptions, to demonstrate that there is an 'economic reserve'. Having demonstrated that it exists, the amount should be limited to an amount calculated using a formula that takes into account the actual profit which has emerged over the last five years (see paragraph 28).

Zillmerisation

7. *Zillmerisation* is an allowance for acquisition costs that are expected, under prudent assumptions, to be recoverable from future *premiums*. *Firms* can make a direct adjustment to their reserves for *zillmerisation*, subject to the rules on *mathematical reserves*. However, where no such adjustment has been made, the FSA will consider an application for a *waiver* to take into account an *implicit item*.

Hidden reserves

8. Hidden reserves are reserves resulting from the underestimation of assets and overestimation of liabilities (other than *mathematical reserves*).

Process for applying for a waiver, including limits applicable when a waiver is granted

9. This annex sets out the procedures to be followed and the form of calculations and data which should be submitted by *firms* to the FSA. This *guidance* should also be read in conjunction with the general requirements relating to the *waiver* process described in SUP 8. The FSA expects that applications for *waivers* in respect of future profits and *zillmerising* will not normally be considered to pass the "not result in undue risk to persons whose interests the *rules* are intended to protect" test unless the relevant criteria set out in this *guidance* have been satisfied and an application for such a *waiver* may require further criteria to be satisfied for this test to be passed. As set out below, *waivers* in respect of either *zillmerising* or hidden reserves will not normally be given except in very exceptional circumstances.

Timing

10. A *long-term insurer* may apply to the FSA for a *waiver* in respect of *implicit items*. A *waiver* will not apply retrospectively (see SUP 8.3.6G). Consequently, applications intended for a particular accounting reference date will normally need to be made well before that reference date. Applications by *firms* must be made to the FSA in writing and include the relevant details specified under SUP 8.3.2D. Given the uncertainty in predicting the future, *waivers* will

normally be granted for a maximum of 12 months at a time and any further applications will need to be made accordingly.

11. The information that will be required to enable an application to be considered as set out below, should normally include a demonstration of how the *capital resources requirement* is to be met, with and without the *waiver*. Clearly, up-to-date information may not be available before the *financial year-end*. In some cases information from the previous year-end's *return* may be used, as long as any known significant changes in the structure of the *firm*, or the assumptions used, have been taken into account.
12. If the application for a *waiver* is granted, when a *firm* submits its next *return* the amount of the *implicit item* shown should not exceed that supported by the *firm's* calculations **as at the valuation date**. In the event that the amount of the future profits item calculated by the *firm* based on these updated assumptions is less than the amount calculated at the time of the *firm's* *waiver* application, the lower figure should be used in the *return*.
13. An *implicit item* in respect of *zillmerising* or hidden reserves is related to the basis on which liabilities or assets have been valued. In the case of hidden reserves, as explained below, the granting of a *waiver* will be dependent on the overall *capital resources* of the *firm*. *Waivers* in respect of these *implicit items* will, therefore, only be made in relation to the position shown in a particular set of *returns* and it will be essential for *firms* to submit applications to the *FSA* well in advance of the latest date for the submission of the relevant *return*.
14. *Waivers* may be withdrawn by the *FSA* at any time (e.g. where the *FSA* considers the amount in respect of which a *waiver* has been given can no longer be justified). This may be as a result of changes in the *firm's* position or as a result of queries arising on scrutiny of the *returns*.

Information to be submitted

15. An application for a *waiver* (which includes an application for an extension to or other variation of a *waiver*) should be prepared using the standard application form for a *waiver* (see *SUP 8 Ann 2D*). In addition, the application should be accompanied by full supporting information to enable the *FSA* to arrive at a decision on the merits of the case. In particular, the application should state clearly the nature and the amounts of the *implicit items* that a *firm* wishes to count against its *capital resources requirement* and the treatment it proposes to adopt in counting the implicit items towards the *firm's* *capital resources*. Furthermore, the application should demonstrate that in allowing for *implicit items* there has been no double counting of future margins and that the basis for valuing such margins is prudent.
16. The *FSA* recognises that the assessment of the insurance *technical provisions* reflects the contractual obligations of the *firm*. *Implicit items* are therefore margins over and above an economic assessment in these *technical provisions* only. Non-contractual "constructive" obligations arising from a *firm's* regulatory duty to treat customers fairly e.g. regarding future terminal bonuses, are not fully captured by the *technical provisions*. A *firm* must instead be satisfied that it has sufficient *capital resources* at all times to meet its obligations under *PRIN 6*. The granting of a *waiver* for an *implicit item* does not in any way detract from this requirement and a *firm* will need to be satisfied that this condition is still met.
17. As a minimum, applications for a future profits *implicit item* should be supported by the information contained in Forms 13, 14, 18, 19, 40, 41, 42, 48, 49, the answers to questions 1 to 12 of the abstract of the valuation report, **Appendix 9.4** of *IPRU(INS)*, the abstract of the valuation report for the realistic valuation, **Appendix 9.4A** of *IPRU(INS)* and Forms 51, 52, 53, 54 and 58. For a *zillmerisation implicit item*, only those items noted above forming part of the abstract valuation report will normally be needed. Applications for a *waiver* in respect of a hidden reserves *implicit item* will normally be considered only if accompanied by the information which is contained in the annual regulatory *returns*. In particular, the balance

sheet forms, *long-term insurance business* revenue accounts, and abstract of the valuation report as set out in **Appendices 9.1, 9.3 and 9.4** of *IPRU(INS)* should be provided. This is not to say that a full regulatory *return* must be provided in the specified format, simply that the information contained in these forms should be provided. Where appropriate, the information may be summarised.

18. The following supporting information relating to the calculation of the amounts claimed should be supplied for each type of implicit item in respect of which a waiver is sought:
 - Future profits: In addition to information related to the prospective calculation and retrospective calculation described below, the profits reported in each of the last five *financial years* up to the date of the most recent available valuation under *rule 9.4* of *IPRU(INS)* which has been submitted to the *FSA* prior to, or together with, the application, and the amounts and nature of any exceptional items left out of account; the method used for calculating the average period to run and the results for each of the main categories of business, both before and after allowing for premature termination (where the calculation has been made in two stages); and the basis on which this allowance has been made.
 - *Zillmerising*: the categories of contracts for which an item has been calculated and the percentages of the *relevant capital sum* in respect of which an adjustment has been made.
 - Hidden reserves: particulars, with supporting evidence, of the undervaluation of assets or the overvaluation of liabilities (other than *mathematical reserves*) for which recognition is sought.

Continuous monitoring by firms

19. *Firms* should take into account any material changes in financial conditions or other relevant circumstances that may have an impact on the level of future profits that can prudently be taken into account. *Firms* should also re-evaluate whether an application to vary an *implicit item waiver* should be made whenever circumstances have changed. In the event that circumstances have changed such that an amendment is appropriate, the *firm* should contact the *FSA* as quickly as possible in accordance with *Principle 11*. (See *SUP 8.5.1R*). In this context, the *FSA* would expect notice of any matter that materially impacts on the *firm's* financial condition, or any *waivers* granted.

Future profits - factors to take into account when submitting calculations to support waiver applications

20. Where an application is made in respect of a *firm* which has separate *with-profit funds* and non-profit funds, the *firm* should ensure that the *capital resources requirement* in respect of the non-profit fund is not covered by future profits attributable to *policyholders* arising in the *with-profits fund*. Furthermore, for a *realistic basis life firm* the amount of the *implicit item* allocated to each *with-profits fund* should be calculated separately, as the amount allocated to each *with-profits fund* will be taken into consideration in the calculation of the *with-profits insurance capital component* (see *PRU 7.4.23R*)
21. *Firms* need to assess prospective future profit (i.e. how much can reasonably be expected to arise) and compare this to maximum limits (in article 27(4) of the *Life Assurance Directive*), which relate to past profits.

Future profits - prospective calculation

22. The application for a *waiver* should be supported by details of a prospective calculation of future profits arising from in-force business. The information supplied to the *FSA* should

include a description of the method used in the calculation and of the assumptions made, together with the results arising. From 31 December 2009 at the latest, future profits *implicit items* will no longer be permitted under the *Life Assurance Directive*. Where a *firm* first applies for an *implicit items waiver* after PRU 2.2 comes into effect, under the prospective calculation a *firm* should only take into consideration future profits that are expected to emerge in the period up to 31 December 2009. Implicit item waivers granted before PRU 2.2 comes into effect will continue to operate under the terms of those waivers, but an application to vary the terms of such a waiver, for example to extend the effective period, is an application for a new waiver for which a *firm* should usually only take into consideration future profits that are expected to emerge in the period up to 31 December 2009.

Assumptions

23. The assumptions made should be prudent, rather than best estimate, assumptions of future experience (i.e. the prudent assumptions should allow for the fair market price for assuming that risk including associated expenses). In particular, it would not normally be considered appropriate for the projected return on any asset to be taken to be higher than the risk-free yield (i.e. assessed by reference to the yield arrived at using a model of future risk free yields properly calibrated from the forward gilts market). It may also be appropriate to bring future withdrawals into account on a suitably prudent basis. For with-profits business, the assumptions for future investment returns should not capitalise future bonus loadings except where the with-profits *policy holders* share in risks other than the investment performance of the fund. Furthermore, the rate at which future profits are discounted should include an appropriate margin over a risk free rate of return. Calculations should also be carried out to demonstrate that the prospective calculation of the future profits arising from the in-force business supporting the application for the *implicit item* would be sufficient to support the amount of the implicit item under each scenario described for use in determining the *resilience capital requirement* – where the *waiver* relates to an *implicit item* allocated to more than one fund, this should be demonstrated separately for that element of the *implicit item* allocated to each fund. For an *implicit item* allocated to a *with-profits fund*, proper allowance should be made for any shareholder transfers to ensure that the *implicit item* is not supported by future profits which will be required to support those transfers. To the extent if any that future profits are dependent on the levying of explicit expense related charges (for example as in the case of unit-linked business) the documentation submitted should include a demonstration of the prudence of the assumptions made as to the level at which future charges will be levied and expenses incurred.

Other limitations on the extent to which waivers for implicit items will be granted to a realistic basis life firm

24. Where a *waiver* in respect of an *implicit item* is granted to a *realistic basis life firm* additional limits may apply by reference to a comparison of *realistic excess capital* and *regulatory excess capital* including allowance for the effect of the waiver. Where the *waiver* relates to an *implicit item* allocated partly or entirely to a *with-profits fund*, the *waiver* will contain a limitation to the effect that the *regulatory excess capital* for that *with-profits fund*, allowing for the effect of the *waiver*, may not exceed that fund's *realistic excess capital*. This limitation will apply on an ongoing basis so that, for example, in the case of an *implicit item* allocated to a *with-profit fund*, the amount of the *implicit item* would be limited to zero whenever the *regulatory excess capital* exceeded the *realistic excess capital* of that fund.

Other charges to future profits

25. To avoid double counting, no account should be taken of any future surplus arising from assets corresponding to explicit items which have been counted towards the *capital resources requirement* such as shareholders funds, surplus carried forward or investment reserves.

Deductions should be made in the calculation of future surpluses for the impact of any other arrangements which give rise to a charge over future surplus emerging (e.g. financial reinsurance arrangements, subordinated loan capital or contingent loan agreements). Deductions should also be made to the extent that any credit has been taken for the purposes of PRU 7.4.43R(2)(c) for the present value of future profits relating to non-profit business written in a non-profit fund. The information supplied to the FSA should identify the amount and reason for any adjustments made to the calculation of the prospective amount of future profits.

26. The *firm* should confirm to the FSA that the calculations have been properly carried out and that there are no other factors that should be taken into account.

Future profits - retrospective calculation

Overriding limit

27. The maximum amount of the *implicit item* relating to future profits permitted under the *Life Assurance Directive* is 50% of the product of the estimated annual profit and the average period to run (not exceeding 6 years (10 years during the transitional period referred to in paragraph 5)) on the *policies* in the portfolio. Article 27(4) of the *Life Assurance Directive* also imposes a further limit on the amount of the *implicit item* equal to 25% of the lower of:

- (1) the *firm's capital resources*; and
- (2) the higher of its *base capital resources requirement for long-term insurance business* and its *long-term insurance capital requirement*.

Once the transitional period set out in article 71(1) of the *Life Assurance Directive* has expired in 2007 (see paragraph 5), the FSA will not allow a *waiver* for more than the amount permitted by article 27(4) of the Directive.

Definition of profits

28. The estimated annual profit should be taken as the average annual surplus arising in the *long-term insurance fund* over the last five *financial years* up to the date of the most recent available valuation which has been submitted to the FSA prior to, or together with, the application. For this purpose, deficiencies arising should be treated as negative surpluses. Where a *firm's financial year* has altered, the surplus arising in a period falling partly outside the relevant five year period should be assumed to accrue uniformly over the period in question for the purpose of estimating the profits arising within the five year period. When there has been a transfer of a block of business into the *firm* (or out of the *firm*) during the period, the impact of the transfer will need to be taken into account to reflect the remaining portfolio.
29. Where a *firm* has been carrying on *long-term insurance business* for less than 5 years, the total profits made during the past 5 years should be taken to be the aggregate of any surpluses that have arisen during the period in which *long-term insurance business* has been carried on less any deficiencies that may have arisen during that period. The resulting total should still be divided by five to obtain the estimated annual profit.

Exceptional items

30. Substantial items of an exceptional nature should be excluded from the calculation of the estimated annual profit. Such items include profits arising from an exceptional change in the value at which assets are brought into account, where this is not reflected in a similar change in the amount of the liabilities, and profits arising from a change in the overall valuation

approach between one year and another. An exceptional loss (i.e. a reduction of an exceptional nature in the surplus arising) may be excluded from the calculation only to the extent that it can be set against a profit or profits up to the amount of the loss and arising from a similar cause. It is not intended, however, that any adjustment should be made for the effect on surplus of a net strengthening of reserves for costs associated with an expansion of the business or for special capital expenditure, such as the purchase of computer systems.

Double counting

31. The inclusion of investment income arising from the assets representing the explicit components of *capital resources* (as part of the estimated annual profit for the purpose of determining the future profits *implicit item*) would result in double-counting. If those assets were required to meet the effects of adverse developments, this would automatically result in the cessation of the contribution to profits from the associated investment income. It would clearly not be appropriate for the FSA to grant a *waiver* which would enable a *firm* to meet the *capital resources requirement* on the basis of counting both the capital values of the assets and the value of the income flow which they can be expected to generate.
32. The definition of the estimated annual profit as the surplus arising in the *long-term insurance fund* ensures that any contribution to surplus arising from transfers from the profit and loss account, including investment income on shareholders' assets, is not included in the estimated annual profit. Thus double-counting should not arise in respect of shareholders' assets. Double-counting may arise, however, in respect of the investment income from the assets representing the explicit components of *capital resources* carried within the *long-term insurance fund* (e.g. surplus carried forward or investment reserves), but the amount of such investment income is not separately identified in the *return*.
33. Where there is reason to suspect that the elimination of any such double-counting would reduce a *firm's capital resources* to close to or below the required level, or would otherwise be significant, the FSA will request this information with a view to taking account of this factor in determining the amount of the *implicit item*. Additional information concerning investment income should be furnished with an application for a *waiver*, if a *firm* believes that any double-counting would fall into one of the categories mentioned above.

Average period to run

34. The average number of years remaining to run on *policies* should be calculated on the basis of the weighted average of the periods for individual *contracts of insurance*, using as weights the actuarial present value of the benefits payable under the contracts. A separate weighted average should be calculated for each of the various categories of contract and the results combined to obtain the weighted average for the portfolio as a whole. Approximate methods of calculation, which the *firm* considers will give results similar to the full calculation, will be accepted. In particular, the FSA will normally accept the calculation of an average period to run for a specific category of contract on the basis of the average valuation factor for future benefits derived from data contained in the abstract of the valuation report in the regulatory *returns*. A *firm* will be asked to demonstrate the validity of the method adopted only where an abnormal distribution of the business in force gives grounds for doubt about its accuracy.
35. Calculations will normally be requested only for the main categories of *insurance business*, accounting for not less than 90% of the *mathematical reserves*, except where there are grounds for expecting that the exclusion of certain categories of *policies* under this provision might have a significant effect on the resulting average period to run. Detailed calculations will not be required where a *waiver* is sought in respect of a low multiple of the annual profits, well within the average period to run for the *firm*.
36. Where, for a particular category of business, a method of valuation is used which does not involve the calculation of the value of future benefits and which is significant for the *firm* in

question, the calculation of the average period to run should be based on estimates of the value of future benefits.

Premature termination of contracts

37. Allowance should be made for the premature termination of *contracts of insurance*, based on the actual experience of the *firm* over the last five years, or other appropriate period, and taking into account specific features of contracts such as options which can be expected to lead to premature termination (e.g. guaranteed surrender values on income bonds written as *long-term insurance contracts* and option dates on flexible whole-life contracts). The adjustment should be made separately for each of the main categories of business. The use of industry-wide rates of termination will be acceptable where a *firm* is satisfied that this will result in sufficient allowance being made having regard to the *firm's* own experience. Methods of calculation that involve a degree of approximation will be permitted.
38. For certain types of contract, where the period left to run is most naturally defined as the term to a fixed maturity or expiry date, the allowance for premature termination should also take into account terminations resulting from death.

Overall limit

39. The overall average period left to run calculated as described above should be limited to a maximum of 6 years under article 27(4) of the *Life Assurance Directive* (or a maximum of 10 years during the transitional period referred to in paragraph 5) before applying it to the estimated annual profit in order to determine the maximum value of the future profits *implicit item*.

Definition of period to run

40. The definition of the period to run and the basis of the allowance for early termination should clearly be considered together. For certain types of contracts (e.g. pension contracts with a range of retirement ages or other options), there is inherent uncertainty about the likely term to run. In such circumstances any estimate for determining the amount of the future profits *implicit item* for which a *waiver* is sought should be based on prudent assumptions tending, if anything, to underestimate the average period to run.

Zillmerising

41. The *FSA* does not normally expect to grant *waivers* permitting *implicit items* due to *zillmerisation* except in very exceptional circumstances. *Zillmerisation* is an allowance for acquisition costs that are expected, under prudent assumptions, to be recoverable from future *premiums*. *Firms* can make a direct adjustment to their reserves for *zillmerisation*, subject to the requirements on *mathematical reserves* set out *PRU 7.3.44R*, and this is the usual approach. However, where no such adjustment has been made, or where the maximum adjustment has not been made in the *mathematical reserves*, the *FSA* will consider an application for an *implicit item*, if the amount is consistent with the amount that would have been allowed as an adjustment to *mathematical reserves* under *PRU 7.3.44R*.

Hidden reserves

42. We will grant *waivers* permitting *implicit items* due to hidden reserves only in very exceptional circumstances. These items relate to hidden reserves resulting from the underestimation of assets and overestimation of liabilities (other than *mathematical reserves*). The rules for the valuation of assets and liabilities (see *PRU 1.3*) which apply to assets and liabilities other than *mathematical reserves* are based on UKGAAP valuation with adjustments for regulatory

prudence such as concentration limits for large holdings, and would not normally be expected to contain hidden reserves.

Case studies on “unduly burdensome”

43. Some examples of situations where the existing *rules* might be considered to be unduly burdensome are given below:-
- A *firm* writes with-profit business. The *firm*’s investment policy is affected by its published financial position. Application of the *rules* without an *implicit item* would result in the *firm* adopting a lower equity backing ratio. It may be possible to demonstrate that, in the circumstances, it would be unduly burdensome to require the *firm* to incur costs (which might prejudice *policy holders*) resulting from the lower equity backing ratio, rather than take allowance for an *implicit item*.
 - A *firm* has purchased a block of in-force business, on which the future profits may be reasonably estimated. However, this asset is given no value under the *rules*. It may be possible to demonstrate that it is unduly burdensome for the *firm* to recognise the cost of acquiring the assets whilst giving no value to the asset acquired.
 - A *firm* has a block of in-force business, on which the future profits may be reasonably estimated. Application of the *rules* without an *implicit item* would result in a need to obtain additional capital. It may be possible to demonstrate that it is unduly burdensome, having regard to the particular circumstances of the *firm*, to require it to incur the costs involved in the injection of further capital rather than take allowance for an *implicit item*.
 - A *firm* has purchased matching assets for guaranteed annuity liabilities. The operation of the asset and liability valuation rules leads to statutory losses in certain circumstances in spite of good matching of assets and liabilities on a realistic basis of assessment. It may be possible to demonstrate that it is unduly burdensome to require the *firm* to incur the costs involved in the injection of further capital rather than take allowance for an *implicit item*.

Conditions which will typically be applied to implicit items waivers

Limits

44. Where *implicit items waivers* are granted, the value cannot exceed (and will normally be less than) the monetary limits described in paragraph 27, except that during the transitional period the pre-Solvency I limits will apply. In addition, time limits will apply and *waivers* will normally only last for 12 months.

Publicity

45. The *FSA* will publish the *waiver* (see *SUP* 8.6 and *SUP* 8.7). Public disclosure is standard practice unless the *FSA* is satisfied that publication is inappropriate or unnecessary (see section 148 of the *Act*). Any request that a direction not be published should be made to the *FSA* in writing with grounds in support, as set out in *SUP* 8.6.
46. Disclosure of a *waiver* will normally be required in the *firm*’s annual *returns*.

2.3 Individual Capital Assessment

Application

- 2.3.1 **R** *PRU 2.3 applies to the firms to which PRU 2.1 applies.*

Purpose

- 2.3.2 **G** *Principle 4 requires a firm to maintain adequate financial resources. PRU 2 sets out provisions that deal specifically with the adequacy of that part of a firm's financial resources that consists of capital resources. The adequacy of a firm's capital resources needs to be assessed both by the firm and the FSA. In PRU 2.1, the FSA sets minimum capital resources requirements for firms. It also reviews a firm's own assessment of its capital needs, and the processes and systems by which that assessment is made, in order to see if the minimum capital resources requirements are appropriate. PRU 1.2 contains rules requiring a firm to identify and assess risks to its being able to meet its liabilities as they fall due, to assess how it intends to deal with those risks and to quantify the financial resources it considers necessary to mitigate those risks. To meet these requirements, a firm should consider the extent to which capital is an appropriate mitigant for the risks identified and assess the amount and quality of capital required. In accordance with PRU 1.2.32R, these assessments must be documented so that they can be easily reviewed by the FSA as part of the FSA's assessment of the adequacy of the firm's capital resources.*
- 2.3.3 **G** *This section (PRU 2.3) sets out guidance on how firms should assess the adequacy of their capital resources, both to comply with the rules in PRU 1.2 and to enable the FSA better to assess whether the minimum capital resources requirements in PRU 2.1 are appropriate. This section also requires firms carrying on general insurance business to calculate their ECR. The ECR for firms carrying on general insurance business is an indicative measure of the capital resources that a firm may need to hold based on risk sensitive calculations applied to its business profile. For realistic basis life firms, the ECR forms part of the calculation of the firm's capital resources requirement (see PRU 2.1.16R). The ECR for such firms requires the calculation of a with-profits insurance capital component (see PRU 7.4) that supplements the mathematical reserves so as to ensure that a firm holds adequate financial resources for the conduct of its with-profits insurance business. In the case of firms carrying on general insurance business and realistic basis life firms, the FSA will use the ECR as a benchmark for its consideration of the appropriateness of the firm's own capital assessment. For firms where an ECR is not calculated the MCR will provide a benchmark for the firm's own capital assessment. For firms generally, the more thorough, objective and prudent a firm's capital assessment is and can be demonstrated as being, the more reliance the FSA will be able to place on the results of that assessment. The FSA will consider the appropriateness of the firm's capital assessment to establish the level of capital resources the firm needs. This may result in the FSA's assessment of a firm's capital resources needs being lower or higher than would otherwise be the case.*
- 2.3.4 **G** *There are two main purposes of this section:*
- (1) *to enable firms to understand the issues which the FSA would expect to see assessed and the systems and processes which the FSA would expect to see in operation for capital adequacy assessments by the firm to be regarded as thorough, objective and prudent;*
 - (2) *to enable firms to understand the FSA's approach to assessing whether the minimum capital resources requirements of PRU 2.1 are appropriate and what action may be taken if the FSA concludes that those requirements are not appropriate to a firm's circumstances.*

Main requirements and guidance

- 2.3.5 G In making an assessment of capital adequacy, the *FSA* requires *firms* to identify the major risks they face and, where capital is appropriate to mitigate those risks, to quantify how much (and what type) of capital is appropriate. To do this, the *FSA* expects *firms* to conduct stress tests and scenario analyses in respect of each risk. For each risk the *firm* will then be able to estimate a range of probable outcomes and hence capital required to absorb losses which might arise. A *firm* must document the results of each of the stress tests and scenario analyses undertaken and should also document, as part of the details of those tests and analyses, the key assumptions including the aggregation of the results.
- 2.3.6 G The assessment which a *firm* makes should be based upon its future business plans and projections. This is the main area where the *firm's* assessment may diverge from its prescribed *capital resources requirement* which, necessarily, is based upon historic data.
- 2.3.7 G In assessing the quality and the amount of *capital resources* projected to be available to meet its projected *capital resources requirement*, a *firm* should consider the timing of its liabilities to repay existing capital together with the prospects for raising new capital in the scenarios considered.
- 2.3.8 G The *FSA* may ask for the results of a *firm's* assessment to be provided to it together with a description of the processes by which the assessment has been made, the range of results from each stress test or scenario analysis performed and the main assumptions made. The *FSA* may also carry out a more detailed examination of the details of the *firm's* processes and calculations.
- 2.3.9 G Based upon this information and other information available to the *FSA*, the *FSA* will consider whether the *capital resources requirement* applicable to the *firm* is appropriate. Where relevant, the *firm's ECR* will be a key input to the *FSA's* assessment of the adequacy of the *firm's capital resources*.
- 2.3.10 **R A *firm* carrying on general insurance business, other than a non-directive insurer, must calculate the amount of its ECR.**
- 2.3.11 **R A *firm* to which PRU 2.3.10R applies must calculate its ECR in respect of its general insurance business as the sum of:**
- (1) the *asset-related capital requirement*; and
- (2) the *insurance-related capital requirement*; less
- (3) the *firm's equalisation provisions*.
- 2.3.12 G Details of the calculation of the *asset-related capital requirement* are set out in *PRU* 3.3.11R to 3.3.16R. Details of the calculation of the *insurance-related capital requirement* are set out in *PRU* 7.2.77R to 7.2.80R.
- 2.3.13 G Where the *FSA* considers that a *firm* will not comply with *PRU* 1.2.17R (adequate financial resources, including *capital resources*) by holding the *capital resources* required by *PRU* 2.1 the *FSA* may give the *firm* individual guidance advising it of the amount and quality of *capital resources* which the *FSA* considers it needs to hold in order to meet that *rule*.
- 2.3.14 G The individual guidance will be given taking into consideration *capital resources* consistent with a 99.5% confidence level over a one year timeframe or, if appropriate to the *firm's* business, an equivalent lower confidence level over a longer timeframe. *Firms* should therefore prepare an individual capital assessment on the same basis. Throughout whatever timeframe is adopted by *firms*, *firms* should ensure that their projected assets

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are, and will continue to be sufficient, to enable their projected liabilities to be paid, and it would be reasonable for *firms* to test that this is the case at the end of each year of the timeframe. *Firms* may also wish to make estimates of capital adequacy using other assumptions for their own internal purposes and are free to do so if they so choose.

- 2.3.15 G If a *firm* considers that the individual guidance is inappropriate to its circumstances, then the *firm* should inform the *FSA* that it does not intend to follow that guidance. Informing the *FSA* of such an intention would be expected if a *firm* is to comply with *Principle 11* (relations with regulators).
- 2.3.16 G The *FSA* expects most disagreements about the adequacy of capital will be resolved through further analysis and discussion. The *FSA* may consider the use of its powers under section 166 of the *Act* (Reports by skilled persons) to assist in such circumstances. If the *FSA* and the *firm* still do not agree on an adequate level of capital, then the *FSA* may consider using its powers under section 45 of the *Act* to, on its own initiative, vary a *firm's Part IV permission* so as to require it to hold capital in accordance with the *FSA's* view of the capital necessary to comply with *PRU 1.2.22R*. *SUP 7* provides further information about the *FSA's* powers under section 45.
- 2.3.17 G Where a *firm* or the *FSA* considers that the *capital resources requirements* of *PRU 2.1* require the holding of more capital than is needed for the *firm* to comply with *PRU 1.2.22R* then the *firm* may apply to the *FSA* for a *waiver* of the requirements in *PRU 2.1* under section 148 of the *Act*. This section sets out the factors which the *FSA* will consider in deciding whether to grant such a *waiver* request, and if so, the terms and extent of any modification to the *rules* in *PRU 2.1*. In addition to the statutory tests under section 148, these will include the thoroughness, objectivity, and prudence of a *firm's* own capital assessment and the extent to which the guidance in this section has been followed.

Stress and Scenario requirement

- 2.3.18 G *PRU 1.2.35R* requires a *firm* to carry out stress tests and scenario analyses for each of the sources of risk identified in accordance with *PRU 1.2.31R*. Using each of the risk categories set out in *PRU 1.2.31R*, 2.3.19 G to 2.3.34 G set out the factors that a *firm* should consider. Annex A to this section provides a practical illustration of how a small *firm* carrying on *general insurance business* might undertake this analysis.

Factors to consider when assessing credit risk

- 2.3.19 G *Credit risk* refers to the risk of loss if another party fails to perform its obligations or fails to perform them in a timely fashion.
- 2.3.20 G In assessing potential *credit risk* events that may affect the *firm's* solvency, a *firm* should allow for:
- (1) the financial effect of non-payment of reinsurance, considering the likelihood both of non-payment of outstanding claims and for the fact that reinsurance cover purchased for underwritten risks may not be effective (i.e. offsetting potential liabilities); and
 - (2) the financial effect of non-payment of premium debtors such as intermediaries and policyholders.
- 2.3.21 G Some further areas to consider in developing the *credit risk* stress tests and scenario analyses might include:

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- (1) the adequacy of the reinsurance programme and whether it is appropriate for the risks selected by the *firm* and adequately takes account of the underwriting and business plans of the *firm* generally;
- (2) the collapse of a reinsurer or several reinsurers on the *firm's* reinsurance programme and the subsequent impact this may have on the *firm's* outstanding reinsurance recoveries and *IBNR* recoveries;
- (3) a deterioration in the creditworthiness of the *firm's* reinsurers, intermediaries or other counterparties;
- (4) the degree of credit concentration. For example, the degree to which a *firm* is exposed to a single counterparty or *group*;
- (5) the degree of concentration of exposure to reinsurers of particular rating grades;
- (6) the prospect of reinsurance rates increasing substantially or reinsurance being unavailable;
- (7) any existing or possible future disputes relating to reinsurance contracts on a pessimistic basis and the extent that they are not already reflected in the value attributed to the reinsurances;
- (8) greater losses from bad debts than anticipated;
- (9) deterioration in the extent and quality of *collateral*; and
- (10) guarantees given by the insurer of the performance of others, whether under insurance contracts or otherwise.

Factors to consider when assessing market risk

- 2.3.22 G *Market* risk includes the risks that arise from fluctuations in values of, or income from, assets or in interest or exchange rates.
- 2.3.23 G In assessing potential *market risk* events that may affect the *firm's* solvency, a *firm* should allow for:
- (1) reduced market values of investments;
 - (2) variation in interest rates and the effect on the market value of investments;
 - (3) a lower level of investment income than planned; and
 - (4) the possibility of counterparty defaults.
- 2.3.24 G Some further areas to consider in developing the *market risk* scenario might include:
- (1) the possibility of a severe economic or market downturn or upturn leading to adverse interest rate movements affecting the *firm's* investment position;
 - (2) unanticipated losses and defaults of issuers;
 - (3) price shifts in asset classes, and their impact on the entire portfolio;

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- (4) inadequate valuation of assets;
- (5) the direct impact on the portfolio of currency devaluation, as well as the effect on related markets and currencies;
- (6) extent of any mismatch of assets and liabilities, including reinvestment risk;
- (7) the impact on the portfolio value of a dramatic change in the spread between a market index of interest rates and the risk-free interest rates; and
- (8) the extent to which market moves could have non-linear effects on values, such as derivatives.

Factors to consider when assessing *liquidity risk*

- 2.3.25 G In accordance with *PRU 1.2.31R* a *firm* should consider the major sources of risk, including *liquidity risks* and assess its response should each risk materialise.
- 2.3.26 G *PRU 5.1* (liquidity risk systems and controls) contains evidential provisions and guidance on how *firms* should meet *PRU 1.2.22R* for liquidity purposes.
- (1) *PRU 5.1.57E* states that a scenario analysis in relation to *liquidity risk* required under *PRU 1.2.35R* should include a cash-flow projection for each scenario tested, based on reasonable estimates of the impact of that scenario on the *firm's* funding needs and sources.
 - (2) *PRU 5.1.82E* states that a *firm* should have a contingency funding plan for taking action to ensure, so far as it can, that in each of the scenarios tested under *PRU 1.2.35(2)R*, it would still have sufficient liquid financial resources to meet liabilities as they fall due.
- 2.3.27 G When assessing *liquidity risk*, the *firm* should consider the extent of mismatch between assets and liabilities and the amount of assets held in highly liquid, marketable forms should unexpected cashflows lead to a liquidity problem. The price concession of liquidating assets is a prime concern when assessing such liquidity risk and should be built into any assessment of capital adequacy.
- 2.3.28 Some further areas to consider in developing the *liquidity risk* scenario might include:
- (1) any mismatching between expected asset and liability cash flows;
 - (2) the inability to sell assets quickly;
 - (3) the extent to which the *firm's* assets have been pledged;
 - (4) the cash-flow positions generally of the *firm* and its ability to withstand sharp, unexpected outflows of funds via *claims*, or an unexpected drop in the inflow of *premiums*; and
 - (5) the possible need to reduce large asset positions at different levels of market liquidity, and the related potential costs and timing constraints.

Factors to consider when assessing operational risk

- 2.3.29 G Operational risk refers to the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.

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- 2.3.30 G A *firm* may wish to refer to SYSC 3A and PRU 6.1 when carrying out its operational risk assessment.
- 2.3.31 G Examples of some issues that a *firm* might want to consider include:
- (1) the likelihood of fraudulent activity occurring that may impact upon the financial or operational aspects of the *firm*;
 - (2) the obligation a *firm* may have to fund a pension scheme for its employees;
 - (3) the technological risks that the *firm* may be exposed to regarding its operations. For example, risks relating to both the hardware systems and the software utilised to run those systems;
 - (4) the reputational risks to which the *firm* is exposed. For example, the impact on the *firm* if the *firm*'s brand is damaged resulting in a loss of policyholders from the underwriting portfolio;
 - (5) the marketing and distribution risks that the *firm* may be exposed to. For example, the dependency on intermediary business or a *firm*'s own sales force;
 - (6) the impact of legal risks. For example a non-insurance related legal action being pursued against the *firm*;
 - (7) the management of employees – for instance staff strikes, where dissatisfied staff may withdraw goodwill and may indulge in fraud or acts giving rise to reputational loss;
 - (8) the resourcing of key functions such as the risk management function by staff in appropriate numbers and with an appropriate mix of skills such as underwriting, claims handling, accounting, actuarial and legal expertise;
- 2.3.32 G A *firm* may consider that investigation of operational weaknesses and corrective action is a better response than holding capital and may consider that a certain degree of operational risk is within its pre-defined risk tolerance. However, until the *firm* corrects any identified deficiencies a *firm* should consider capital as a (interim) response to the risk.

Factors to consider when assessing insurance risk

- 2.3.33 G As a result of the differences between the nature of *general* and *long-term insurance business*, some aspects of the risk assessment vary depending on the type of business written. In assessing potential insurance risk events that may affect the *firm*'s solvency, *general* and *long-term insurance business firms* should:
- (1) analyse the potential for catastrophic losses, including both risk and event losses, the cost of reinstatement premiums and any possible reinsurance exhaustion; and
 - (2) determine the likelihood of any other feature of insurance risk that may lead to a variation in projected outcomes.
- Firms* carrying on *general insurance business* should in addition:
- (1) analyse the potential for claims reserves to deteriorate beyond the current reserving level; and
 - (2) determine the effect of loss ratios being higher than planned by analysing historic loss ratio experience and volatility.

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Firms carrying on long term insurance business should in addition:

- (1) analyse the potential for *mathematical reserves* subsequently to prove inadequate compared with the current reserving level; and
- (2) determine the effect of claims experience being more costly than planned by analysing historic claims experience, volatility and trends in experience.

2.3.34

G Some further areas to consider in developing the insurance risk scenario might include:

For underwriting risks, general insurance business and long term insurance business firms:

- (1) the adequacy of the *firm's* pricing. For example, the *firm* should be able to satisfy itself that it can charge adequate rates, taking into account the business and the risk profile of different products, the business environment (e.g. premium cycle-non-life) and its own internal profit targets;
- (2) the uncertainty of claims experience;
- (3) the dependence on intermediaries for a disproportionate share of the *insurer's* premium income; the effects of a high level of uncertainty in pricing in new or emerging underwriting markets due to a lack of information needed to enable the *insurer* to make a proper assessment of the price of the risk; the geographical mix of the portfolio or whether any geographical or jurisdictional concentrations exist;
- (4) the appropriateness of policy wordings;
- (5) the risk of mis-selling, for example, the number of complaints or disputed claims; and
- (6) the tolerance for expense reserve variations or variations in expenses (including indirect costs).

For *firms* carrying on *general insurance business*, in addition:

- (1) the length of tail of the claims development and latent claims; and
- (2) the effects of rapid growth or decline in the volume of the underwriting portfolio.

For *firms* carrying on *long-term insurance business*, in addition:

- (1) the uncertainty of future investment returns;
- (2) the effects of rapid growth or decline in the volume and nature of new business written; and
- (3) the ability of *firms* to adjust premium rates or charges for some products.

For reserving and claims risks, both general insurance business and long term insurance business firms:

- (1) the frequency and size of large claims;

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- (2) possible outcomes relating to any disputed claims, particularly where the outcome is subject to legal proceedings;
- (3) the ability of the *firm* to withstand catastrophic events, increases in unexpected exposures, latent claims or aggregation of claims;
- (4) the possible exhaustion of reinsurance arrangements, both on a per risk and per event basis;
- (5) social changes regarding an increase in the propensity to claim and to sue; and
- (6) other social, economic and technological changes.

For *firms* carrying on *general insurance business*:

- (1) the adequacy and uncertainty of the technical claims provisions, such as outstanding claims, *IBNR* and claims handling expense reserves;
- (2) the adequacy of other underwriting provisions, such as the provisions for *unearned premium* and unexpired risk reserves;
- (3) the appropriateness of catastrophe models and underlying assumptions used, such as possible maximum loss (PML) factors used;
- (4) unanticipated legal judgements and legal change with retrospective effect specifically with regard to the claims reserves; and
- (5) the effects of inflation.

For *firms* carrying on *long-term insurance business*:

- (1) the adequacy and sensitivity of the *mathematical reserves* to variations in future experience, including:
 - (a) the risk that investment returns differ from those assumed in the reserving assumptions;
 - (b) the risk of variations in mortality, morbidity and persistency experience and in the exercise of options under contracts;
 - (c) the rates of taxation applied, in particular where there is uncertainty over the tax treatment; and
- (2) unanticipated legal judgements and legal change with retrospective effect specifically with regard to the impact on *mathematical reserves*.

Other assessments of the adequacy of capital resources

- | | | |
|--------|---|---|
| 2.3.35 | G | <i>Firms</i> must assess the adequacy of their financial resources and this will entail an assessment of both <i>capital resources</i> and liquidity resources. The stress tests and scenario analyses which a <i>firm</i> must carry out will assist with both assessments. However, <i>firms</i> may also find it helpful to approach their assessment of capital in another way. |
| 2.3.36 | G | <i>Firms</i> may also wish to carry out an additional assessment to inform their view as to whether their <i>capital resources</i> are adequate. The additional assessment is to consider |

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the extent to which the *capital resources requirement (CRR)* produces adequate capital for a *firm's* particular circumstances. In considering this, *firms* that are required to calculate an *Enhanced Capital Requirement (ECR)* may wish to note that the *ECR* as calculated is based upon the assumptions that a *firm's* business is well diversified, well managed with assets matching its liabilities and good controls, and stable with no large, unusual, or high risk transactions. *Firms* may find it helpful to assess the extent to which their actual business differs from these assumptions and therefore what adjustments it might be reasonable to make to the *CRR* or *ECR* to arrive at an adequate level of *capital resources*.

- 2.3.37 G *Firms* may find it helpful for their own assessment process if they also consider divergences from the assumptions described in PRU 2.3.36G under the headings set out below. These are the areas which the FSA considers when forming its view of the adequacy of a *firm's capital resources*.

Business risk factors:

- (1) *market risk*;
- (2) *securitisation risk*;
- (3) *residual risk*;
- (4) *concentration risk*;
- (5) *high impact, low probability events*; and
- (6) *cyclicality and capital planning*

Control risk factors:

- (1) *systems and controls*

- 2.3.38 G **Market risk:** a *firm* should assess its exposure to those elements of *market risk* that are not captured by the *CRR*. In doing so *firms* may wish to use stress tests to determine the impact on their balance sheets of an appropriate move in market conditions. The results of this test should then be used by the *firm* to determine its *market risk*.
- 2.3.39 G **Securitisation risk:** a *firm* should assess its exposure to risks transferred through the securitisation of assets should those transfers fail for whatever reason. For instance, *firms* may contemplate two broad types of securitisation: 'embedded value securitisation' – the transfer of the value emerging from an existing block of business to bondholders; and 'risk transfer securitisation' – the purchase of protection against catastrophic risks to the *insurer* through the issuance of bonds whose repayment is contingent upon the non-occurrence of such risks. In either case *firms* should consider the effect on their financial position of a failure of such complex arrangements to operate as anticipated or the values and risks transferred not emerging as expected.
- 2.3.40 G **Residual risk:** a *firm* should assess its exposure to the residual risks that may result from the partial performance or failure of risk mitigation techniques for reasons that are unconnected with their intrinsic value. This could result from (for example): ineffective documentation, a delay in payment or the inability to realise payment from a guarantor in a timely manner. Given that residual risks can always be present, *firms* should assess the appropriateness of their *capital resources requirement* against their assumptions for the risk mitigation measures that they may have in place.
- 2.3.41 G **Concentration risk:** a *firm* should assess and monitor its exposure to: sector, geographic, liability and asset concentrations, as well as granularity. The FSA considers that

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concentrations in these areas increase the *firm's* credit risk and where the *firm* identifies concentrations then they should consider the adequacy of the *capital resources requirement*. For instance, *firms* should monitor concentrations of exposure to particular reinsurers and ensure that they are aware of the implications of several of their reinsurers failing at the same time.

- 2.3.42 G **High impact, low probability events:** *firms* should consider stress tests and scenario analyses which are realistic – that is not too remote a possibility. However, should a *firm* decide to enter into a high impact, low probability transaction, the *firm* should satisfy itself that it has sufficient financial resources to meet its resulting financial obligation in the event the single risk materialises. For instance, a *firm* should not accept individual risks in circumstances where, if that single risk materialised, the claim arising would exceed the financial resources available to the *firm*.
- 2.3.43 G A *firm* should also consider the value of the financial obligation arising where the risks from a combination of high impact, low probability transactions that the *firm* has entered into materialise at the same time. A *firm* should ensure that in no circumstances would a combination of any consequent claims materially exceed the financial resources available to it.
- 2.3.44 G **Cyclical and capital planning:** a *firm's capital resources requirement* may vary as business cycles and economic conditions fluctuate over time. *Firms* should be aware that a deterioration in business or economic conditions could require them to raise capital or alternatively to contract their businesses at a time when market conditions are most unfavourable to raising capital. Such an effect is known as procyclicality.
- 2.3.45 G To reduce the impact of cyclical effects, *firms* should look to build-up capital levels through the course of an upturn in business and economic cycles to ensure that they have sufficient capital available to protect themselves against adverse conditions.
- 2.3.46 G To assess its expected capital requirements over the economic and business cycles, a *firm* may wish to project forward its financial position taking account of its business strategy and expected growth under a range of environmental assumptions. Projections over a three to five year period would be appropriate in most circumstances. *Firms* may then calculate their projected *capital resources requirement* and assess whether that requirement could be met from expected financial resources.
- 2.3.47 G **Systems and controls:** A *firm* may decide to hold additional *capital resources* to mitigate weaknesses in its overall control environment. Weaknesses might be indicated by the following:
- (1) a failure by the *firm* to complete an assessment of its systems and controls in line with SYSC 3.1 (Systems and Controls) and PRU 1.4;
 - (2) a failure by the *firm's* senior management to approve its financial results; and
 - (3) a failure by the *firm* to consider an analysis of relevant internal and external information on its business and control environment.
- 2.3.48 G In considering any systems and control weaknesses and their effect on the adequacy of the *capital resources requirement*, a *firm* may wish to be able to demonstrate to the FSA that all the issues identified in SYSC 3.2 (Areas covered by systems and controls) have been considered; and that appropriate plans and procedures exist to deal adequately with adverse scenarios.

Capital models

- 2.3.49 G A *firm* may approach its assessment of adequate *capital resources* by developing a model for some or all of its business risks. Where such a model captures some of the risks identified in accordance with *PRU* 1.2.31R then this will usually satisfy the requirement to perform stress tests in respect of those risks. However, the assumptions required to aggregate risks modelled and the confidence levels adopted should be considered by the *firm's* senior management. A *firm* should also consider whether any risks are not captured by the model and also the extent to which systems and control risks are not incorporated in the model.
- 2.3.50 G A *firm* should not expect the *FSA* to accept as adequate any particular model that it develops or that the results from the model are automatically reflected in any individual *guidance* given to the *firm* for the purpose of determining adequate *capital resources*. However, the *FSA* will take into account the results of any sound and prudent model when giving individual *guidance* or considering applications for a *waiver* under section 148 of the *Act* of the *capital resources requirement* in *PRU* 2.1. This section sets out the types of issues the *FSA* would consider before giving individual *guidance* or granting a *waiver* based on the results of a model.
- 2.3.51 G There is no prescribed modelling approach for how a *firm* develops its internal model. However, *firms* should be able to demonstrate:
- (1) the extent of use of the internal capital model within the *firm's* capital management policy;
 - (2) that sound and appropriate risk-management techniques are employed and are embedded in the daily operations and financial resources requirements of the *firm*;
 - (3) that all material risks to which the *firm* is exposed have been adequately addressed by quantitative and qualitative means as appropriate;
 - (4) the confidence levels set and whether these are linked to the *firm's* corporate strategy;
 - (5) the time horizons set for the different types of business that the *firm* undertakes;
 - (6) the extent of historic data used and back testing carried out; and
 - (7) whether sufficient accuracy and validation in the internal capital model has been undertaken.

Quantitative factors

- 2.3.52 G The *firm's* model should be based on an appropriate probability of insolvency over an appropriate time period. A *firm* should be able to demonstrate the selected probability of insolvency and time horizon it has derived and explain why these are appropriate for its business.
- 2.3.53 G Good models will have as inputs (in addition to the specific examples given under the stress and scenario guidance):

For both *general insurance business* and *long-term insurance business firms*:

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- (1) assumed future investment returns. In particular, assumptions for future interest rates (to the extent that they impact on interest income on funds on deposit, price of and yield on fixed stock that may be purchased in future and interest income on variable interest rate assets), equity prices, dividend income, property prices, property rental income and inflation. The assumptions should take account of likely volatility and historic volatility in interest rates and asset prices;
- (2) five-year predictions as to premium rates in each homogeneous category of business taking account of the effect of underwriting cycles;
- (3) predictions of exposures written in each homogeneous category of business in the next five years;
- (4) predictions of premium volume and expected growth under a five year business plan;
- (5) expenses and commission;
- (6) catastrophic events, aggregations of claims and claims affecting more than one class of business;
- (7) inflation in terms of how it might affect future claims, non-settled claims that have occurred to date, future expenses, future reinsurance costs and future investment returns;
- (8) reinsurance programmes in place, allowing for changing term conditions, reinstatements and loss experience features;
- (9) estimates of non-recovery of reinsurance and other debtors taking account of the financial strength of each reinsurance or other counter-party; and
- (10) foreign exchange movements.

For *firms* carrying on *general insurance business* in particular:

- (11) frequency and severity of claims (including costs associated with claims such as professional fees) for each homogeneous category of business, allowing for any impact of future social, legal and inflationary effects (especially concerning price, earnings, medical and claims) on future claims costs;
- (12) settlement patterns of claims and reinsurance recoveries for each homogeneous category of business (including occurred and future claims);
- (13) unintended coverage of risks; and
- (14) correlation between these risks.

For *firms* carrying on *long-term insurance business* in particular:

- (15) projected claims experience for each homogeneous category of business allowing for trends in mortality/ morbidity experience;
- (16) assumptions for future policyholder actions such as lapsing or surrendering a policy, ceasing to pay premiums or choosing to exercise an option under the contract; and

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- (17) for business where management has discretion over the level of benefits or charges, assumptions about management reactions to changes in economic conditions and consequent changes to the benefits or charges.

- 2.3.54 G The *FSA* places credence in approaches to financial models to aid the assessment of capital adequacy which involve the production of a Dynamic Financial Analysis (“DFA”) model. These models transform each element in the financial projection into a statistical distribution with a range of possible outcomes, and are therefore stochastic. They would generally incorporate a suitable economic model integrated into the DFA model and linked into the generation of insurance related assumptions. The model would, as far as possible, cover all risks and all areas of business. The future time period over which projections are made should be determined with reference to the type of insurance business written, the asset profile and the insurance cycle. It may be appropriate to consider several different time periods.
- 2.3.55 G Due regard should also be given to the historical experience of both the *firm* and the wider relevant industry and market when assigning values to the above inputs.
- 2.3.56 G The values assigned to each of the above inputs should be derived either stochastically by assuming the value of an item can follow an appropriate probability distribution and by selecting appropriate values at the tail of the distribution, or deterministically using appropriate prudent assumptions. For *long-term insurance business* which includes options or guarantees that change in value significantly in certain economic or demographic circumstances, a stochastic approach would normally be appropriate.

Annex A

- A.1 This Annex provides an illustrative qualitative example of how a small *firm* could undertake its stress and scenario analysis without this being disproportionate to the size and complexity of its business so as to comply with *PRU* 1.2.35R. For these reasons, the example does not provide any quantitative guidance as we believe this would be impractical given the diverse nature of each *firm*'s individual circumstances.
- A.2 This example is based on guidance contained in *PRU* 2.3. The areas discussed are not exhaustive and it is likely that in practice a *firm* will need to consider a range of other issues.
- A.3 The scenarios that the *firm* generates as part of its analysis should aim to reflect the degree of risk in a variety of areas. How extreme these scenarios are will influence the ultimate level of capital required by the *firm*. The *firm* should not necessarily develop scenarios based on the current trading or economic conditions, but on possible trading or economic conditions that could occur during the next three to five years.
- A.4 In addition to examining its event scenarios, a *firm* should also be able to meet any individual risk (however unlikely) that it has accepted (or proposes to accept through its business plan) from policyholders. It therefore should analyse its exposures and ensure that it has sufficient capital or available reinsurance to cover its largest individual risks and accumulations.

Worked example

Background:

- A.5 The *firm* used for this example is a *general insurance business insurer* within a large *group* writing predominantly personal lines household and motor policies of approximately £25m *gross written premium*. This business has a reasonable geographical spread, sourced significantly from within the UK. The *firm* has purchased appropriate reinsurance cover from a variety of reinsurers and has a demonstrated record of utilising this cover. Its settlement pattern for claims averages 3 years, however, there is a small element of the account with longer tail liability claims. The *firm*'s investments and IT support are outsourced.

Insurance risk

- A.6 The risk of incorrect or inaccurate pricing of business over the scenario period can be addressed by examining typical uncertainties within the pricing basis and the volatility of claims experience.
- A.7 In examining the adequacy of its pricing, the *firm* establishes its underwriting and claims trend over a ten-year base period by reviewing profit and loss accounts (particularly underwriting profit). In particular it examines the following:
- the volatility of losses in a particular line of business;
 - whether the loss ratio exceeded 100% in any line of business; and
 - whether the Deferred Acquisition Cost (DAC) amount had been written down; e.g. whether an unexpired risk provision (URP) was necessary.
- A.8 The *firm* also examines whether its premiums over the last ten years have been:
- reasonably stable;
 - responsive enough to changes in claim exposures (so that profitability is maintained);

- providing adequately for contingencies (such as major losses e.g. hail, earthquake etc);
- encouraged loss control (through the use of deductibles, no claim bonuses etc);

A.9 The *firm* also reviews its method of pricing. The *firm* considers and performs the following:

- a review of acceptable rates, e.g. premiums being charged by competitors for similar products;
- an examination of whether there have been any difficulties in the past with delegated authorities in relation to pricing including the ability and experience of staff members setting or recommending premium prices;
- an examination of whether the *firm* has the appropriate mechanisms in place regarding premium rate changes (i.e. who makes these decisions, frequency, and on what basis); and
- a benchmark price assessment (e.g. the ability to provide adequate competitive premium rates). For example, indicative rates being determined through the use of industry statistics, competitor statistics and the *firm's* own analysis for all classes.

A.10 Other factors the *firm* considers are:

- changes in environment (e.g. legislation, social, economic etc);
- changes in policy conditions and deductibles; and
- impact of market segments (e.g. the effects of different claim frequencies and costs impacting the price charged).

A.11 Having completed its analysis, the *firm* makes the following assumptions to define its underwriting risk:

- claims costs. The *firm* assumes these are X% higher than in the premium basis;
- claims inflation. The *firm* assumes a X% claims inflation over the scenario period, compared to Y% in the pricing basis;
- policy expenses (fixed and variable) are X% higher than anticipated in the pricing basis;
- reinsurance charges are X% higher than anticipated in the pricing basis; and
- investment income is X% lower than anticipated in the pricing basis.

As a result of the above analysis on a per risk basis, the *firm* considers that capital of between £X and £Y would cover the possibility of material deviations to projected results.

Allowing for catastrophes

A.12 The allowance for catastrophic events within the insurance risk scenario should reflect both the severity and the frequency of these events.

- A.13 After considering the catastrophe reinsurance program it may be clear that the upper limit is set at a level unlikely to be breached e.g. a 1 in 200 year event. Thus for the purposes of the capital assessment, it would not be necessary to assume losses in excess of this retention.
- A.14 However it may be determined that there is possible exhaustion of free reinstatements or of horizontal cover in total. For example if there were a significant chance of 3 catastrophic losses in any one period but the reinsurance allowed only 1 free reinstatement, then the assessment may be to hold 2 retentions and the entire gross loss for the third event.

As a result of the above analysis, the *firm* considers it appropriate to hold capital sufficient to absorb 3 catastrophic losses: one European Windstorm of £X, one UK Flood of £Y, and one large man made explosion of £Z.

The reinsurance structure in place allows for X number of reinstatements at full premium.

Deterioration of reserves

- A.15 The *firm* considers the adequacy of its claims reserves by focussing on the liability valuation.
- A.16 The liability valuation may contain a range of answers that might indicate possible reserve variability. Also, the valuation will contain areas where judgement has been applied and assumptions formulated which are subjective. These areas are considered and stressed as appropriate.
- A.17 The *firm* also reviews the historic level of claims reserves and subsequent level of settlements to help determine the size of any historic levels of under and over reserving.
- A.18 Reinsurance arrangements are considered and the extent to which these arrangements protect against reserve deterioration are assessed.
- A.19 For *unearned premium*, where losses have yet to occur, the *firm* considers that the level of uncertainty is greater and considers similar factors to those relating to underwriting risk in addition to those discussed above.

As a result of the above analysis, the *firm* considers it appropriate to apply a X% loading to the outstanding claims provision, a Y% loading to the *unearned premium* provision and Z% to all other liability values. The *firm* considers that capital of between £X and £Y would adequately cover reserve deterioration.

Credit risk

- A.20 Credit risk relates to the risk of default by counterparties. The *firm* believes its exposure to credit risk results from financial transactions with counterparties including issuers, debtors, borrowers, brokers, policyholders, reinsurers and guarantors.
- A.21 When assessing credit risk the *firm* makes an assessment of the creditworthiness of counterparties to the assets of the *firm*.
- A.22 The assessment includes an evaluation of the credit risk associated with loans and investment portfolios; the quality of on and off balance sheet assets; the ongoing management of the loans and investment portfolios; as well as loss provisions and reserves.
- A.23 The *firm* believes its exposure to credit risk also arises due to its exposure to its reinsurers. In this regard, the *firm* uses the credit ratings assigned to particular counterparties as a measure of credit risk, most notably Standard & Poor's, Moody's Investors Service and AM Best's (particularly for reinsurers).

A.24 When forming an opinion on credit risk the *firm* considers:

- **Reinsurance**

A.25 The *firm's* strategy is to lessen exposure to a single lead reinsurer to less than 30%, with other participants holding no more than 15%. In all cases, the panel of reinsurers all have a specified rating. The *firm* has no prior experience of disputes, and their working relationship with the panel may be excellent, and thus the *firm* does not envisage any future difficulties arising in this regard.

A.26 Bond default rates could then be used to assess a likely credit risk figure for reinsurance recoveries (including IBNR recoveries).

The *firm* considers that capital of between £X and £Y would cover reinsurance defaults, with no additional allowance for disputes.

- **Overseas financial institutions and banks**

A.27 The *firm* investigates its business relationships with overseas financial institution counterparties including banks, and decides no additional allowance is required.

- **Quality of counterparties and trends in counterparty risk**

A.28 The *firm* assesses the level and age of debtors, focussing particularly upon unpaid premiums, especially those greater than three months old, and reviews the level and trend of contingent liabilities. For example, the *firm* estimates that the credit risk scenario equates to taking a 10% reduction in the asset value of debtors, based on bond default rates and age of debt.

The *firm* considers that capital of between £X and £Y would cover credit risk to counterparties.

- **Off-balance sheet transactions**

A.29 The *firm* investigates any unfunded commitments, credit derivatives, commercial or standby letters of credit. Where these exist the possibility of a loss on these instruments is considered in relation to the requirement of the credit risk scenario.

The *firm* considers that no additional capital is necessary.

Market risk

A.30 *Market risk* encompasses an adverse movement in the value of the assets as a consequence of market movements such as interest rates, foreign exchange rates, equity prices, etc which is not matched by a corresponding movement in the value of the liabilities.

A.31 In examining possible market risks, the *firm* considers its sensitivity to *market risk* by evaluating the degree to which changes in interest rates, foreign exchange rates, equity prices, or other areas can adversely affect the *firm's* earnings or capital.

A.32 The *firm* believes its assets and liabilities are approximately matched e.g. there is no existence of large unmatched or unhedged currency positions; short tail business is backed by cash/fixed interest assets of suitable term and long tail business with real assets e.g. shares/property. If mismatching does exist this should be allowed for within the estimate.

- A.33 In developing the scenario the *firm* estimates the effect of a X% increase in interest rates on bond values.
- A.34 Similarly the *firm* estimates the effect on equity values of a major recession to estimate the possible reduction in the value of equity capital. Also it uses a suitable equity index to determine the size of historical falls in equity values and indicate possible future falls.
- A.35 Counterparty risk might be allowed for by assuming one or several major corporate bond holding defaults.
- A.36 For all investments, the stability of trading revenues should be examined to determine the volatility of investment.

From the above analysis, the *firm* considers that capital of between £X and £Y would be appropriate to protect it against adverse movement in *market risks*.

Liquidity risk

- A.37 *Liquidity risk* is the potential that the *firm* may be unable to meet its obligations as they fall due as a consequence of having a timing mismatch. The *firm* considers *liquidity risk* relates to the risk associated with the processes of managing timing relationship between asset and liability cash flow patterns.
- A.38 When assessing *liquidity risk*, the *firm* considers the extent of mismatch between assets and liabilities and the amount of assets held in a highly liquid, marketable form should unexpected cashflows lead to a liquidity crunch.
- A.39 The price concession of liquidating assets is a prime concern when assessing *liquidity risk* and is built into the scenario.
- A.40 In examining the *liquidity risk*, the *firm* examines the following:

▪ Marketability, quality and liquidity of assets

- A.41 The *firm* considers the assets held and makes an assessment regarding the quality and liquidity of these assets. Even though the assets matched the liabilities, residual risk remains given that timings are uncertain and there is a possibility that assets will be realised at unfavourable times. This is allowed for by assuming a 2.5% reduction in the market value of assets at realisation compared to the current market value.

The *firm* considers that capital of between £X and £Y would cover timing risk to counter-parties.

▪ Reliance on new business income

- A.42 The *firm* relies partially upon new business cash flows to meet current liabilities as they fall due. The *firm* analyses the sensitivity of future cash flow projections and new business assumptions and considers the effect of a reduced level of new business.
- A.43 The *firm* finds that it did not have immediate alternatives in place in case these expected new business cash flows were reduced. In this regard, it considers that these sources should be stressed by X%.

The *firm* considers that capital of between £X and £Y would cover possible effects of adjusting the asset portfolio to switch to more liquid assets.

- A.44 The *firm* also examines the volatility and cost of on- and off-balance sheet funding sources. The *firm* is satisfied that no concerns need to be raised and that there should not be any impact on its liquidity position.
- A.45 The *firm* believes it is well placed to manage unplanned changes in funding sources as well as react to changes in market conditions that affect its ability to quickly liquidate assets with minimal loss. The *firm* assesses that it has reasonable access to money markets and other sources of funding such as lines of credit.
- A.46 The *firm* has no previous problems or delays in meeting obligations (or accessing external funding).

Overall, from the above analysis, the *firm* considers that capital of between £X and £Y would be necessary to withstand the effects of deterioration in liquidity.

Governance Risk

- A.47 Governance risk relates to the risk associated with the board and/or senior management of the *firm* not effectively performing their respective roles.
- A.48 The existence and level of directors and officers insurance in place is investigated compared to known incidence of claims of this type.
- A.49 The *firm* assesses whether the current level of governance is appropriate for the *firm*, and the likelihood that the *firm's* practices may result in the board and/or senior management not adequately undertaking their roles. The cost of altering and strengthening the current board structure is considered.
- A.50 In this regard, the *firm* makes an assessment that it may be reliant on only a few senior executives, and may be exposed if they experience any misadventure.

The *firm* considers that capital of between £X and £Y would cover governance risk.

Strategic Risk

- A.51 Strategic risk arises from an inability to implement appropriate business plans and strategies, make decisions, allocate resources or adapt to changes in the business environment.
- A.52 The *firm* therefore assesses the prudence and appropriateness of its business strategy in the context of the *firm's* competitive and economic environment. In particular the assumptions, forecasting and projections are assessed considering the possibility of a fundamental market change due, for example, to higher numbers of competitors, changes in sales channels, new forms of insurance or changes in legislation. This review includes whether the reinsurance program is appropriate for the risks selected by the *firm* and whether it adequately takes account of the underwriting and business plans of the *firm* generally.
- A.53 The *firm* considers the likelihood of a fundamental strategic shift too remote to include within the scenario given the maturity of the market in which they operate.

Operational risks

A.54 In reviewing the operational risk exposures, the *firm* has examined its administration, compliance, event, fraud, governance, strategic and technological risks.

▪ **Administration**

A.55 The *firm* considers the risk of error or failure associated with the administrative aspects of the operation of its business. In this regard, the *firm* considers likelihood of financial loss and reputation harm due to failure or errors occurring and the likely size of these losses.

A.56 None of the *firm's* administration is out-sourced to service providers.

A.57 In undertaking the assessment, the *firm* considers the history of failure or error from transaction processing or control within the *firm*. Exception reports are produced on a quarterly basis. Past reports highlighted past administrative deficiencies. The biggest event in the past 10 years related to a situation where claim-handling staff shared access codes to the claims administration system. This resulted in an overpayment to some clients.

A.58 The *firm* also examines the nature and extent of centralised and decentralised functions within the *firm*. Three branches report regularly to the central office and an appropriate system is in place to record financial information, handle complaints etc.

A.59 The *firm* also reviews the segregation of duties between staff. It is satisfied that an adequate segregation of duties between underwriting claims and payments divisions exist in terms of acceptance, authorisation and payments. It is also satisfied that sufficient interaction between the front, middle and back offices exist in terms of financial control and risk management. For example, it is confident that its guidelines for accepting risks are adequate and that any breach would be picked up by exception reporting.

A.60 The *firm* also investigates the level of staff expertise and training to administer its product range/services.

The *firm* considers that capital of between £X and £Y would cover the risk of future administration issues.

▪ **Compliance Risk**

A.61 The *firm* believes its main compliance risk relates to the risk of non-adherence to legislative and internal *firm* requirements.

A.62 An investigation into compliance over the last 10 years finds no history of non-compliance with *firm* policy and control systems nor have there been any reported areas of non-compliance with legislation or other requirements.

A.63 Regulatory reforms including corporate and consumer law are considered and it is assumed that expenses costs will rise as a result of developments in the next 5 years. As a result an additional X% of premium income was assumed for the expense ratio.

The *firm* considers that capital of between £X and £Y would cover the risk of future compliance issues.

▪ **Event risk**

- A.64 Event risk relates to risks associated with the potential impact of significant events (e.g., financial system crisis, major change in fiscal system, natural disaster) on the operations of the *firm*.
- A.65 The definition of event risk is not intended to cover events that are directly associated with products and services offered, for example, events which may directly impact on the general insurance business.
- A.66 The *firm* concludes that no additional specific allocation is required.

▪ **Fraud Risk**

- A.67 Fraud risk relates to the risk associated with intentional misappropriation of funds, undertaken with the objective of personal benefit at the expense of the *firm*.
- A.68 In assessing fraud risk, the *firm* considers the possibility of fraudulent acts occurring within the *firm* and the extent of controls which management has established to mitigate such acts.
- A.69 The *firm* examines fraud issues over a period of 10 years and finds one major incident where it was subject to a fraudulent activity. This involved fraudulent payments being made by a member of staff which resulted in a loss for the *firm* of £Xm. Based on this previous incident and allowing for improvements in controls, the company assessed a financial figure that it believes is consistent with the probability for this scenario.

The *firm* considers that capital of between £X and £Y would cover the risk of future fraud.

▪ **Technology Risk**

- A.70 The *firm* considers the risk of error or failure associated with the technological aspects (IT systems) of its operations. Specifically technology risk refers to both the hardware systems and the software utilised to run those systems.
- A.71 In relation to the *firm's* information systems, the *firm* assesses the past reliability and future functionality and believes them to be adequate. It does not have any future plans to either replace its systems or make major systems modifications.
- A.72 Concerning business continuity management and disaster recovery planning (and testing of plans), the *firm* reviews these plans regularly and tests them quarterly. A full back-up site exists with full recovery capabilities. Costs associated with utilising the site and associated business interruption insurance were estimated.

The *firm* considers that capital of between £X and £Y would cover technology risk.

Group risk

- A.73 The size of the group risk element within operational risk will depend on the ownership structure of the *firm* and how it is funded by the parent.
- A.74 The *firm* considers the likelihood and financial consequences of both insolvency and credit downgrading of its parent. Given the *firm* shares the parent's name there is a large risk of association.
- A.75 The *firm* considers it within the scope of the scenario to allow for a single downgrade of the parent's credit rating from AA to A. It does not believe the chance of insolvency great enough to allow for directly.

- A.76 The *firm* estimates the effect on its business plan and profit margins of the downgrade. It estimates the amount of business lost and the increase in marketing costs required to maintain the client base. It also allows for a change in the pricing basis to incorporate a reduced profit margin (with knock on impacts on the business volume and loss ratios).

From the above analysis, the *firm* considers that capital of between £X and £Y would be required to cover group risks.

Overall assessment

- A.77 After individually assessing each risk area, the *firm* considers the capital that it has estimated might be absorbed under each scenario. In aggregate the range of capital absorbed is between £X and £Y. It considers how many of these scenarios might reasonably occur within a period and the extent to which it could replace capital within that period. It takes into account scenarios which might reasonably be linked, the difficulty with which capital might be replaced if the scenarios occurred, and the changes in strategy which might need to be adopted if the scenarios occurred.

The *firm* decides that the worst realistic combination of circumstances that might arise would absorb capital of between £A and £B.

3.2 Credit risk in insurance

Application

- 3.2.1 R This section applies to *insurers*, referred to as *firms* in this section.
- 3.2.2 R This section does not apply to a *firm* which is:-
- (1) a *non-directive friendly society*;
 - (2) an *incoming EEA firm*; or
 - (3) an *incoming Treaty firm*.
- G The scope of application of PRU3.2 is not restricted to *firms* that are subject to relevant EC directives. It applies, for example, to pure reinsurers.
- 3.2.4 R (1) This section applies to a *firm* in relation to the whole of its business, except where a particular provision provides for a narrower scope.
- (2) Where a *firm* carries on both *long-term insurance business* and *general insurance business*, this section applies separately to each type of business.

Purpose

- 3.2.5 G The purpose of this section is to protect *policyholders* and potential *policyholders* by setting out the requirements applicable to a *firm* in respect of credit risk. Credit risk is incurred whenever a *firm* is exposed to loss if a *counterparty* fails to perform its contractual obligations including failure to perform them in a timely manner. Credit risk may therefore have an impact upon a *firm's* ability to meet its valid *claims* as they fall due. A detailed explanation of credit risk is given at PRU 3.1.3G.
- 3.2.6 G Credit risk can also arise from underlying causes that have an impact upon the credit worthiness of all *counterparties* of a particular description or geographical location. The *rules* and *guidance* in this section seek to protect against credit risk by requiring a *firm* to limit and diversify its exposure and to hold sufficient financial resources to withstand credit loss in so far as such loss is reasonably possible.
- 3.2.6 G The requirements address both current and contingent exposure to credit risk. *PRIN*, *SYSC* and PRU 1.4 require a *firm* to establish adequate internal systems and controls for exposure to credit risk. This section requires a *firm* to restrict its exposure to *counterparties* to prudent levels, adequately diversify its exposure to *counterparties* and make prudent provision for credit loss. It also prohibits a *firm* from taking into account for the purposes of its regulatory balance sheet exposures to one asset, *counterparty* or group of closely related *counterparties* in excess of prescribed limits.
- 3.2.7 G Current exposure means exposure under existing circumstances. Contingent exposure means exposure that would arise if circumstances change (but only in so far as such change is reasonably possible).
- 3.2.8 G The requirements in this section apply to exposure arising both from a direct *counterparty* relationship and from credit risk transfer. The section also draws attention to credit insurance, credit *derivatives* and *reinsurance* as sources of credit risk.
- 3.2.9 G This section also sets limits on the market risk arising from holding assets including *securities* issued or guaranteed by *counterparties*. This market risk is incurred whenever a *firm* is exposed to loss if an asset were to reduce in value or even become worthless. These market risk limits are set in this section rather than the market risk sections in PRU because they are closely linked to the

counterparty limits set in this section.

Overall limitation of credit risk

- 3.2.10 R** Taking into account relevant risks, a *firm* must:
- (1)** restrict its *counterparty* and asset exposures to prudent levels and ensure that those exposures are adequately diversified; and
 - (2)** make a prudent provision for credit loss based on its assessment of those risks so that it will remain able to meet its liabilities as they fall due.
- 3.2.11 R** (1) For the purposes of PRU 3.2.10R, PRU 3.2.23R and PRU 3.2.25R, *counterparty* exposure is the amount a *firm* would lose if a *counterparty* were to fail to meet its obligations (either to the *firm* or to any other person) and if simultaneously *securities* issued or guaranteed by the *counterparty* were to become worthless.
- (2) For the purposes of PRU 3.2.10R, PRU 3.2.23R and PRU 3.2.25R, asset exposure is the amount a *firm* would lose if an asset or class of identical assets (whether or not held directly by the *firm*) were to become worthless.
- (3) For the purposes of (1) and (2) the amount of loss is amount, if any, by which the *firm's* capital resources (as calculated in accordance with the Table in PRU2.2.14R but without making any deduction for assets in excess of market risk and counterparty limits) would decrease as a result (either directly, indirectly through exposures held by *related undertakings* or thorough synthetic exposures arising from *derivatives* or *quasi-derivatives*) of the *counterparties* failing to meet their obligations and the securities or assets becoming worthless.
- 3.2.12 G** As exposure is defined in terms of loss (which is decrease in capital) it does not include exposures arising from assets that are not represented in capital or exposures which if crystallised in a loss would be offset by a consequent gain, reduction in liabilities or release of provisions, but only in so far as that gain, reduction or release would itself lead to an offsetting increase in *capital resources*. Examples include:
- (1) exposure from the holding of assets to which the *firm* has attributed no value;
 - (2) exposure from the holding of assets that the *firm* has deducted from *capital resources*;
 - (3) exposure in respect of which (and to the extent that) the *firm* has established a provision; and
 - (4) exposure to the extent that it has been mitigated by an *approved derivative* or *approved quasi-derivative*. An exposure to a *derivative counterparty* will be created.
- 3.2.13 G** In assessing the adequacy of diversification required by PRU 3.2.10 R, a *firm* should take into account concentrations of exposure including those arising from:
- (1) different types of exposure to the same *counterparty*, such as deposits, loans, *securities*, *reinsurance* and *derivatives*;
 - (2) links between *counterparties* such that default by one might have an impact upon the creditworthiness of another; and
 - (3) possible changes in circumstance that would have an impact upon the credit worthiness of all *counterparties* of particular description or geographical location.

PRU 3.2 Credit risk in insurance

- 3.2.14 G Firms should consider how the spreading of credit risk will impact on overall *counterparty* quality.
- 3.2.15 G For the purpose of determining prudent provision for credit loss required by PRU 3.2.10R the factors to be taken into account by a *firm* should include:
- (1) the creditworthiness of the *counterparties*;
 - (2) the likely timing and duration of the exposure;
 - (3) the use of any loss mitigation techniques.
- 3.2.16 G In assessing its exposure to a *counterparty* for the purpose of PRU 3.2.10 R, a *firm* should take into account:
- (1) the period for which the exposure to any *counterparty* might continue;
 - (2) the likelihood of default during that period by the *counterparty*; and
 - (3) the loss that might result in the event of default.
- 3.2.17 G In assessing the loss that might result from the default of a *counterparty* for the purposes of PRU 3.2.10 R, a *firm* should take into account the circumstances that might lead to default and, in particular, how these might have an impact upon:
- (1) the amount of exposure to the *counterparty*; and
 - (2) the effectiveness of any loss mitigation techniques employed by the *firm*.
- 3.2.18 G Often the same circumstances which lead to the crystallisation of contingent credit exposure, e.g. a significant *claims* event or a significant movement in interest, currency or asset values, also lead to an increase in the risk of default by the *counterparty*. In particular, if a *reinsurer* or *derivative counterparty* is being relied upon to provide protection against the consequences of an event or circumstance, a *firm* should take into account how that event or circumstance might have an impact upon the credit worthiness of the *reinsurer* or *derivative counterparty*.
- 3.2.19 R For the purpose of PRU 3.2.10 R and of calculating exposure in accordance with PRU 3.2.11R, a *firm* must only rely upon a loss mitigation technique where it has good reason to believe that, taking into account the possible circumstances of default, it is likely to be effective.**
- 3.2.20 G Loss mitigation techniques include:
- (1) the right, upon default, to preferential access to some or all of the *counterparty's* assets, for example by exercising rights of set off, holding *collateral* or assets deposited back, or exercising rights under fixed or floating charges;
 - (2) rights against third parties upon default by the *counterparty*, such as guarantees, credit insurance and credit *derivatives*; and
 - (3) where the *counterparty* is a *reinsurer*, having back-up or flexible *reinsurance* which covers the gap in coverage left by the *reinsurer's* default, for example 'top and drop' *reinsurance*.
- 3.2.21 R For the purpose of PRU 3.2.10 R and of calculating exposure in accordance with PRU 3.2.11R, a *firm* must not rely upon preferential access to a *counterparty's* assets unless it has taken into account appropriate professional advice as to its effectiveness.**
- 3.2.22 G In particular, a *firm* should consider whether any preferential access to the *counterparty's* assets would be effective even if the *counterparty* were wound up by a court or other legal process or it were to be subject to any other insolvency process. A *firm* should also consider, where it is relying upon a right against a third party, whether, in the circumstances of the *counterparty's* default, the credit worthiness of that third party might be impaired.

Large exposure limits

- 3.2.23 R **A *firm* must take reasonable steps to limit its exposure (other than from *approved credit institutions*) to a single *counterparty*, or group of closely related *counterparties*, so that the *firm* would not become unable to meet its liabilities as they fall due as a result, if that were to occur, of that *counterparty* or all *counterparties* within the closely related group failing to meet its or their obligations and simultaneously any *securities* issued or guaranteed by it or them becoming worthless.**
- 3.2.24 G In assessing its exposure to a *counterparty* or group of closely related *counterparties* a firm should consider exposures from different sources including deposits, loans, *securities* and *derivatives*.

Market risk and counterparty limits

- 3.2.25 R **(1) A *firm* must calculate the amount of the deduction from capital required in the Table in PRU2.2.14R in respect of market risk and *counterparty* limits as the amount by which its exposures exceed the relevant limits set out in PRU 3.2.25 R(3).**
- (2) Except where the contrary is expressly stated in PRU, whenever a rule in PRU refers to the assets of a *firm*, or of any part of or fund within a *firm*, the *firm* must deduct from the measure of the value of the assets (as determined in accordance with PRU 1.3.6R) the amount of the deduction referred to in (1), or that portion of the deduction that relates to the part or fund.**
- (3) The limits referred to in PRU 3.2.25R(1) are the following, expressed as a percentage of the aggregate of the *firm's* gross *technical provisions*, the amount of its other liabilities, the amount of its *general insurance capital requirement*, the amount of its *long-term insurance capital requirement* and the amount of its *resilience capital requirement*:**
- (a) for a *counterparty* exposure to an individual, unincorporated body of individuals or a group of closely related individuals or unincorporated bodies of individuals:**
 - (i) $\frac{1}{4}\%$ for that part of the exposure that arises from *unsecured debt*;**
 - (ii) 1% for the whole exposure (after deduction of the excess arising from the limit in (a)(i));**
 - (b) for a *counterparty* exposure to an *approved credit institution* or a group of closely related *approved credit institutions*:**
 - (i) 5% for that part of the exposure not arising from short term deposits; this limit is increased to 10% if the total of such exposures which exceed 5% are less than 40%;**
 - (ii) 20% or £2 million if larger for the whole exposure (after**

deduction of the excess arising from the limit in (b)(i));

- (c) for a *counterparty* exposure to a person, or group of closely related persons, who do not fall into the categories of *counterparty* to whom (a) and (b) apply:
 - (i) 1% for that part of the exposure arising from *unsecured debt*;
 - (ii) 1% for that part of the exposure arising from *shares*, bonds, *debt securities* and other *money market instrument* and capital market instruments from the same *counterparty* that are not dealt in on a *regulated market*, or any beneficial interest in a *non-eligible investment trust*;
 - (iii) 5% for the whole exposure (after deduction of the excesses arising from the limits in (c)(i) and (ii));
- (d) 5% for the aggregate of all *counterparty* exposures that fall within (c)(i) whether or not they arise from persons who are closely related, but excluding amounts that are in excess of the limit in (c)(i);
- (e) 10% for the aggregate of all *counterparty* exposures that fall within (c)(ii) whether or not they arise from persons who are closely related, but excluding amounts that are in excess of the limit in (c)(ii);
- (f) 3% for the asset exposure arising from all cash in hand;
- (g) 10% for the asset exposure arising from any one piece of land or building, or a number of pieces of land or buildings close enough to each other to be considered effectively as one investment.

- 3.2.26 G Where there is doubt as to which of the limits in PRU 3.2.25R(2) an aggregate exposure to a group of closely related *counterparties* is subject a *firm* should discuss the issue with the FSA to determine how the exposure should be treated.

Large exposure calculation for reinsurance exposures

- 3.2.27 R A *firm* must notify the FSA in accordance with SUP15.7 as soon as it first becomes aware that:
- (1) an exposure to a *reinsurer*, or group of closely related *reinsurers*, is reasonably likely to exceed 100% of its *capital resources* excluding capital held to cover *property linked liabilities*; or
 - (2) if (1) does not apply that it has exceeded this limit.
- 3.2.28 R Upon notification under PRU 3.2.27R a *firm* must:
- (1) demonstrate that prudent provision has been made for the exposure in excess of the 100% limit, or explain why in the opinion of the *firm* no provision is required; and
 - (2) explain how the exposure is being safely managed.
- 3.2.29 G The explanation should be approved by a person at the *firm* of appropriate seniority.
- 3.2.30 R For the purposes of PRU 3.2.27R, a *reinsurance* exposure is the maximum amount of loss which a *firm* might suffer if a *reinsurance counterparty* or

group of closely related reinsurance counterparties fail to meet their obligations.

- 3.2.31 R Any reinsurance exposure, the reinsurer of which is unknown to the firm, should be aggregated to the highest reinsurance exposure of which the firm is aware.**
- 3.2.32 G The purpose of PRU 3.2.31R is to help ensure that adequate provision is made with respect to an *reinsurer*, the identity of which is unknown.
- 3.2.33 G The notification requirement at PRU 3.2.27R gives an opportunity for a *firm* to demonstrate that despite the high concentrations of credit risk the *firm* is prudently managing its exposure.
- 3.2.34 G PRU 3.2.10 R provides that, taking into account relevant risks, a *firm* must restrict to prudent levels, and adequately diversify, its exposure to *counterparties*, and make a prudent provision for credit loss, so that it will remain able to meet its liabilities as they fall due.
- 3.2.35 E To comply with PRU 3.2.10 R, in each *financial year*, a *firm* should restrict the *gross earned premiums* which it pays to a *reinsurer* (or group of closely related *reinsurers*) to the higher of:
- (1) 20% of the *firm's* projected gross earned *premiums* for that *financial year*; or
 - (2) £4million.
- Compliance with this provision may be relied upon as tending to establish compliance with PRU 3.2.10(1) R.
- 3.2.36 G For the purposes of PRU 3.2.35 E, *gross earned premiums* should be calculated in accordance with generally accepted accounting practice.
- 3.2.37 R A firm must notify the FSA immediately in accordance with SUP 15.7 if it has exceeded, or anticipates exceeding, the limit expressed in PRU 3.2.35 E.**
- 3.2.38 R Upon notification under PRU 3.2.37R a firm must explain to the FSA how despite the excess reinsurance concentration the credit risk is being safely managed.**
- 3.2.39 G The explanation should be approved by a person at the *firm* of appropriate seniority.
- 3.2.40 G Where a firm can demonstrate that the arrangement does not give rise to unacceptable levels of credit risk it is unlikely that further action will be required.

Exposures excluded from the large exposure limits

- 3.2.41 R In PRU 3.2.23R and PRU 3.2.25R references to an exposure do not include exposure arising from:**
- (1) *secured debts*;
 - (2) *premium debts*;
 - (3) *reinsurance debts and the reinsurers' share of technical provisions*;
 - (4) *advances secured on, and not exceeding the surrender value of, long-term insurance contracts of the firm*;
 - (5) *rights of salvage or subrogation*;
 - (6) *deferred acquisition costs*;
 - (7) *assets held to cover index-linked liabilities or property-linked liabilities, save that where the linked long-term contract of insurance in question includes a guarantee of investment performance or some*

other guaranteed benefit, PRU 3.2.23R and PRU 3.2.25R will nevertheless apply to assets held to cover that guaranteed element;

- (8) *moneys due from, or guaranteed by, a Zone A country;*
- (9) *an approved security;*
- (10) *a holding in a UCITS scheme.*

3.2.42 R For the purposes of PRU 3.2.23 R, PRU 3.2.25 R and PRU 3.2.27 R, exposures may be calculated net of *collateral*.

3.2.43 R For the purposes of PRU 3.2.25R and PRU 3.2.27R, any part of an exposure which is:

- (1) guaranteed by a *credit institution* or an *investment firm* subject in either case to the CAD or supervision by a third country (non EEA) supervisory authority with a CAD equivalent regime; or
- (2) adequately protected by a *credit derivative*;

may be treated as an exposure to the guarantor or *derivative counterparty*, rather than to the original *counterparty*.

3.2.44 G The portion of exposure which is guaranteed or protected by a *credit derivative* is itself, as an exposure to the guarantor or *derivative counterparty*, subject to the limits in PRU 3.2.23 R and PRU 3.2.25 R.

3.2.45 R For the purposes of PRU 3.2.23 R and PRU 3.2.25 R, an investment fund is to be treated as closely related to its *issuer*.

3.2.46 G For the purposes of PRU 3.2.28 R and PRU 3.2.38 R, a *firm's* explanation of how a *reinsurance* credit exposure is being safely managed should also describe the *reinsurance* market in which the exposure has occurred, and the nature of the *reinsurance* contract. If appropriate, the *firm* should also provide a detailed plan and timetable explaining how the excess exposure will be reduced to an acceptable level.

Definitions

3.2.47 R For the purposes of PRU 3.2:

a group of persons is closely related if it comprises solely of two or more natural or legal persons who, unless it is shown otherwise, constitute a single risk because as between any pair of them one or other of the following relationships apply:

- (1) one of them, directly or indirectly, has control, as defined in PRU 3.2.48R over the other or others or they are both controlled by the same third party; or
- (2) there is no relationship of control as defined in PRU 3.2.48R but they are to be regarded as constituting a single risk because they are so interconnected that, if one of them were to experience financial problems, the other would be likely to encounter repayment difficulties.

3.2.48 R For the purposes of PRU 3.2.47R, control means the relationship between a parent undertaking and a subsidiary, as defined in Article 1 of the

Consolidated Accounts Directive (83/349/EEC), or a similar relationship between any natural or legal person and an undertaking.

3.3 Asset-related Capital Requirement

Application

- 3.3.1 R ***PRU 3.3 applies to insurers, referred to as firms in this section.***
- 3.3.2 R ***PRU 3.3 does not apply to:***
- (1) ***a non-directive friendly society; or***
 - (2) ***a Swiss general insurer; or***
 - (3) ***an EEA-deposit insurer; or***
 - (4) ***an incoming EEA firm; or***
 - (5) ***an incoming Treaty firm.***
- 3.3.3 G The scope of application of *PRU 3.3* is not restricted to *firms* that are subject to the relevant EC directives. It applies, for example, to *pure reinsurers*.
- 3.3.4 R ***PRU 3.3 applies to a firm only in relation to its general insurance business.***
- 3.3.5 G The adequacy of a *firm's* financial resources needs to be assessed in relation to all the activities of the *firm* and the risks to which they give rise.
- 3.3.6 G The requirements in *PRU 3.3* apply to a *firm* on a solo basis.

Purpose

- 3.3.7 G *PRU 2.1.10R* requires that a *firm* must maintain at all times *capital resources* equal to or in excess of its *capital resources requirement*. *PRU 2.1.15R* provides that for a *firm* carrying on *general insurance business* the *firm's capital resources requirement* is the *Minimum Capital Requirement*.
- 3.3.8 G The *FSA* will use the *Enhanced Capital Requirement* as the benchmark for individual capital guidance for a *firm* carrying on *general insurance business*, other than a *non-directive insurer*. The *Enhanced Capital Requirement* is the sum of the *asset-related capital requirement* and the *insurance-related capital requirement* less the *firm's equalisation provisions*. This section sets out *rules and guidance* relating to the *asset-related capital requirement*. *Rules and guidance* relating to the *insurance-related capital requirement* are set out in *PRU 7.2*.
- 3.3.9 G The *asset-related capital requirement* is a measure of the capital that a *firm* should hold against the risk of loss if another party fails to perform its financial obligations to the *firm* or from adverse movements in the value of assets.
- 3.3.10 G The *asset-related capital requirement* is calculated by applying capital charge factors, expressed as a percentage, to different categories of a *firm's* assets. *Firms* should refer to *PRU 1.3* which sets out how a *firm* must recognise and value assets and liabilities.

Calculation of asset-related capital requirement

- 3.3.11 R A *firm* must calculate its *asset-related capital requirement* in accordance with PRU 3.3.12R.
- 3.3.12 R
- (1) The value of each of the *firm's* assets of a kind listed in the table in PRU 3.3.16R must be multiplied by the corresponding capital charge factor.
 - (2) If any amount which is to be multiplied by a capital charge factor is a negative amount, that amount shall be treated as zero.
 - (3) No account shall be taken of:
 - (a) the value of any asset which is not an *admissible asset*;
 - (b) the amount (if any) by which the value of any assets exceeds the limits on *exposures* to a type of asset or *counterparty* as set out in PRU 3.2.25R.
 - (4) Where a *firm* has entered into a *derivative*, then for the purposes of applying the appropriate capital charge factor as set out in PRU 3.3.16R, it must treat the value of the *derivative* and the value of the asset associated with the *derivative* as a single asset of a type and value which most closely reflects the economic risk to the *firm* of the combined rights and obligations associated with the *derivative* and the asset associated with the *derivative*.
 - (5) The amounts resulting from multiplying each of the asset items referred to in (1) by the corresponding capital charge factor must be aggregated.
 - (6) The *asset-related capital requirement* is the amount resulting from the aggregation in (5).
- 3.3.13 G *Options*: some *derivatives* may allow a *firm* an *option* whether to buy or sell a particular asset. If an *option* has a positive market value (that is, in-the-money) it is likely that the *firm* will exercise the *option* in the future and the current value of the *derivative* and associated asset will generally acquire new characteristics and volatility (a 'synthetic asset'). For instance, an *option* to acquire *shares* at a price below their current market value is likely to be exercised and the appropriate *asset-related capital requirement* calculation would be to combine the cash cost of acquiring the number of *shares* covered by the *option* with the value of the *derivative* and apply a factor of 16% to that combined value. If an *option* has no market value (that is, out-of-the-money) then it is unlikely that a *firm* would exercise the *option* in which case the appropriate *asset-related capital requirement* charge would be zero in respect of the *derivative*, and the corresponding capital charge contained in Table PRU 3.3.16R in relation to the asset associated with the *derivative*.

- 3.3.14 G *Futures and swaps: futures or swaps may not allow the firm such an option in which case the appropriate asset-related capital charge factor to apply is the one corresponding to the asset that would be held on fulfilment of the contract and the value to which this should be applied would be the value of the asset held after the contract is fulfilled.*
- 3.3.15 R (1) **The asset-related capital charge factor for money market funds set out in the Table *PRU 3.3.16R* must be applied to *exposures* to funds that meet the definition in (2).**
- (2) **In *PRU 3.3* an *investment* in a money market fund means a participation in a *collective investment scheme* which satisfies the following conditions:**
- (a) **The primary *investment* objective of the *collective investment scheme* is:**
- (i) **to maintain the net asset value of the *collective investment scheme* constant at par (net of earnings); or**
- (ii) **to maintain the net asset value of the *collective investment scheme* at the value of investors initial capital plus earnings;**
- (b) **in order to pursue its primary *investment* objective the *collective investment scheme* invests exclusively in cash or in short term instruments with characteristics similar to cash or both; and**
- (c) **the *collective investment scheme* undertakes to abide by the following conditions:**
- (i) **not to allow the assets held in the *collective investment scheme* to exceed a weighted average maturity of 60 days;**
- (ii) **not to invest in equity or *securities* with characteristics similar to equity; and**
- (iii) **on a basis of marking-to-market at least weekly, not to permit the value of each *collective investment scheme* unit at any point in time to move by more than 50 basis points (0.5% of total *collective investment scheme* value).**

3.3.16R Table: Asset-related capital charge factors

Asset item				ECR asset- related capital charge factor	
Investments	Land and Buildings			7.5%	
	Investments in group undertakings and participating interests	Shares in group undertakings	Insurance dependants	0%	
			Other	7.5%	
		Debt securities issued by, and loans to, group undertakings			3.5%
		Participating Interests			7.5%
		Debt securities issued by, and loans to, undertakings in which the insurer has a participating interest			3.5%
	Other financial investments	Shares and other variable-yield securities and units in unit trusts			16.0%
		Money market funds			0%
		Debt securities and other fixed income securities	Approved securities		3.5%
			Other		3.5%
		Participation in investment pools			16.0%
		Loans secured by mortgages			2.5%
		Other loans			2.5%
		Deposits with approved credit institutions and approved financial institutions			0%
		Other			7.5%
		Deposits with ceding undertakings			3.5%
Reinsurers' share of technical provisions	Provision for unearned premium			2.5%	
	Claims outstanding			2.5%	
	Other			2.5%	
Debtors	Debtors arising out of direct insurance operations	Policyholders		4.5%	
		Intermediaries		3.5%	
	Debtors arising out of reinsurance operations			2.5%	
	Other debtors			1.5%	
	Called up share capital not paid			0%	
Other Assets	Tangible assets			7.5%	
	Cash at bank and in hand			0%	
	Other			0%	
Prepayments and accrued income	Accrued interest and rent			0%	
	Deferred Acquisition Costs			0%	
	Other prepayments and accrued income			0%	

4.2 Market risk in insurance

Application

- 4.2.1 R This section applies to *insurers*, referred to as *firms* in this section.
- 4.2.2 R This section does not apply to a *firm* which is:
- (1) a *non-directive friendly society*; or
 - (2) an *incoming EEA firm*; or
 - (3) an *incoming Treaty firm*.
- 4.2.3 G The scope of application of *PRU 4.2* is not restricted to *firms* that are subject to the relevant EC directives. It applies, for example, to *pure reinsurers* (with the exception of *PRU 4.2.56R*).
- 4.2.4 R (1) This section applies to a *firm* in relation to the whole of its business, except where a particular provision provides for a narrower scope.
- (2) Where a *firm* carries on both *long-term insurance business* and *general insurance business*, this section applies separately to each type of business.

Purpose

- 4.2.5 This section sets out *rules* and *guidance* relating to *market risk*. Under *PRU 7.2.21R* a *firm* is required to hold *admissible assets* of a value sufficient to cover *technical provisions*. In addition, *PRU 7.2.35R* sets the requirement that a *firm* must hold assets of appropriate amount, currency, term, safety and yield, to ensure that the cash inflows from those assets will be sufficient to meet expected cash outflows from its insurance liabilities as they are due.
- 4.2.6 G *Market risk* is the risk that as a result of market movements a *firm* may be exposed to fluctuations in the value of its assets, the amount of its liabilities, or the income from its assets. Sources of general *market risk* include movements in interest rates, equities, exchange rates and real estate prices. It is important to note that none of these sources of risk is independent of the others. For example, fluctuations in interest rates often have an impact upon equity and currency values and vice versa. Giving due consideration to these correlations is an important aspect of the prudent management of *market risk*.
- 4.2.7 G A *firm* may also be exposed to specific *market risk*, which is the risk that the *market value* of a specific asset, or income from that asset, may fluctuate for reasons that are not dependent on general market movements. The limits in *PRU 3.2.25R* cover *market risk* as well as *counterparty risk*.
- 4.2.8 G *PRU 4.2* addresses the impact of *market risk* on *insurance business* in the ways set out below:
- (1) Any *firm* that carries on *long-term insurance business* must comply with the *resilience capital requirement*. This requires the *firm* to hold capital to cover *market risk*. The *resilience capital requirement* is dealt with in *PRU 4.2.10G* to *PRU 4.2.27R*.

- (2) For a *firm* that carries on *long-term insurance business*, the assets that it must hold must be of a value sufficient to cover the *firm's mathematical reserve* requirements. *PRU 7.3* contains *rules* and *guidance* as to the methods and assumptions to be used in calculating these *mathematical reserves*. One of these assumptions is the assumed rate of interest to be used in calculating the present value of future payments by or to a *firm*. *PRU 4.2 29R* to *PRU 4.2.51G* set out the methodology to be used in relation to *long-term insurance liabilities*.
- (3) *Firms* carrying on either *long-term insurance business* or *general insurance business* are also subject to currency risk. That is, the risk that fluctuations in exchange rates may impact adversely on a *firm*. *PRU 4.2.52G* to *4.2.59G* set out the requirements a *firm* must meet so as to cover this risk.
- (4) For a *firm* carrying on *general insurance business*, the *Enhanced Capital Requirement* already captures some elements of *market risk*. In addition, the requirements as to the assumed rate of interest used in calculating the present value of *general insurance liabilities* are contained in the *insurance accounts rules*, and these requirements are outlined in *PRU 4.2.28G*.
- (5) *Firms* carrying on *long-term insurance business* that have *property-linked liabilities* or *index-linked liabilities* must cover these liabilities by holding appropriate assets. *PRU 4.2.60R* to *4.2.64G* set out these cover requirements.

DEFINITIONS

4.2.9 R For the purposes of *PRU 4.2*:

- (1) **real estate means an interest in land, buildings or other immovable property;**
- (2) **a significant territory is any country or territory in which more than 2.5% of a *firm's long-term insurance assets (by market value)* are invested; and**
- (3) **the long term gilt yield means the annualised equivalent of the fifteen year gilt yield for the United Kingdom Government fixed-interest securities jointly compiled by the Financial Times, the Institute of Actuaries and the Faculty of Actuaries.**

Resilience capital requirement (applicable to long-term insurance business only)

- 4.2.10 G The *resilience capital requirement* forms part of the calculation of the *capital resources requirement* for all *firms* carrying on *long-term insurance business*. *PRU 2.1.16R* to *PRU 2.1.21R* set out the different elements of this calculation. These include the *Minimum Capital Requirement* and the *Enhanced Capital Requirement*. The *resilience capital requirement* forms part of both of these requirements (see *PRU 2.1.23R(2)* and *PRU 2.1.35R(2)*).
- 4.2.11 R (1) **A *firm* that carries on *long-term insurance business* must calculate a *resilience capital requirement* in accordance with (2) to (5).**

- (2) From amongst its *long-term insurance assets*, the *firm* must identify a range of assets (the “corresponding assets”) in such a way that the assets in the range are of a value that is equal to the *firm’s long-term insurance liabilities*.
- (3) The *firm* must identify other assets (the “supplementary assets”), the value of which is equal to any shortfall in the value of the corresponding assets as compared to its *long-term insurance liabilities* that would result from combining the following scenarios:
 - (a) for those assets invested in the UK, the *market risk* scenario set out in *PRU 4.2.17R*;
 - (b) subject to (c) and to *PRU 4.2.27R*, for those assets invested outside of the UK, the *market risk* scenario set out in *PRU 4.2.24R*; and
 - (c) where the assets in (b) are not invested in a significant territory outside the UK, the *market risk* scenario set out in *PRU 4.2.17R*.
- (4) If a shortfall arises, the *firm* must also calculate any reduction in the value of the supplementary assets that would result from the combination of the scenarios referred to in (3)(a), (b) and (c).
- (5) The *resilience capital requirement* is the sum of:
 - (a) the value of the supplementary assets calculated in accordance with (3); and
 - (b) the value of assets required to meet any reduction in the value of the supplementary assets calculated in accordance with (4).

4.2.12 G The purpose of the *resilience capital requirement* is to cover adverse deviation from:

- (1) the value of *long-term insurance liabilities*;
- (2) the value of assets held to cover *long-term insurance liabilities*; and
- (3) the value of assets held to cover the *resilience capital requirement*;

arising from the effects of *market risk* for equities, real estate and fixed interest *securities*. Other risks are not explicitly addressed by the *resilience capital requirement*.

4.2.13 G The amount of the *resilience capital requirement* calculated by the *firm* will depend on the *firm’s* choice of assets held to cover the *resilience capital requirement*. The *resilience capital requirement* is held to cover not only the shortfall between the change in the value of *long-term insurance liabilities* and the change in the value of the assets identified to cover those liabilities, but also the change in the value of the assets identified to cover the *resilience capital requirement* itself.

- 4.2.14 G As part of the assessment of the financial resources a *firm* needs to hold to comply with *PRU 1.2.22R*, *PRU 1.2.35R* requires a *firm* to carry out stress tests and scenario analyses appropriate to the major sources of risk to its ability to meet its liabilities as they fall due identified in accordance with *PRU 1.2.31R*. In considering the stress tests and scenario analyses relevant to the major sources of risk in the category of *market risk*, a *firm* should consider the extent to which the *market risk* scenarios set out in *PRU 4.2.17R* to *4.2.27R* are appropriate to the nature of its asset portfolio. A *firm* may judge that given the nature of its portfolio, a more severe stress should be adopted. The *firm* may also wish to bring in other asset classes, such as index-linked bonds, which should be stressed on appropriate bases, and to consider the impact of currency mismatching and any *derivative* positions held.
- 4.2.15 G The *resilience capital requirement* requires *firms* to assume different adverse *market risk* scenarios for equities, real estate and fixed interest *securities* (see *PRU 4.2.17R* and *PRU 4.2.24R*) to those required by *PRU 7.4.65R* (UK assets) and *PRU 7.4.70R* (non-UK assets) in relation to the calculation of the *risk capital margin* for a *with-profits fund* by a *realistic basis life firm* calculating its *with-profits insurance capital component*.
- 4.2.16 G Where the *resilience capital requirement* is affected by the presence of *derivative* or *quasi-derivative* instruments the *firm* will need to consider whether the protection afforded is of suitable length or security. The *firm* should include the exposure to counterparties in the credit considerations of *PRU 4.2.42R* both before and after calculating the *resilience capital requirement*. If the *derivative* protection is very short term the *firm* should consider whether issues arise under *PRU 7.3.27R* (Avoidance of future valuation strain); when a *derivative* expires the financial position of the firm may deteriorate as a result of, for example, falls in asset values. Unless the *firm* holds a further reserve the *firm* is likely to need to have either undertaken a fresh protection strategy or carried through the alternative to the *derivative* protection (such as selling *equities* in place of a put *option*) if the existing protection expires before the financial year end. If the existing *derivative* protection continues beyond the time of financial year end the firm must have sufficient confidence that it can renew its *derivative* protection or an alternative to achieve the same effect.

MARKET RISK SCENARIO FOR ASSETS INVESTED IN THE UK

- 4.2.17 R In *PRU 4.2.11R(3)(a)*, the *market risk* scenario for assets invested in the UK which a *firm* must assume is:
- (1) a fall in the market value of equities of at least 10% or, if greater, the lower of:
 - (a) a percentage fall in the market value of equities which would produce an earnings yield on the FTSE Actuaries All Share Index equal to 4/3rds of the long-term gilt yield; and
 - (b) a fall in the market value of equities of 25% less the *equity market adjustment ratio* (see *PRU 4.2.20R*);
 - (2) a fall in real estate values of 20% less the *real estate market adjustment ratio* for an appropriate real estate index (see *PRU 4.2.22R*);
 - (3) (a) the more onerous of either a fall or rise in yields on all fixed interest *securities* by the percentage point amount determined in (b);

- (b) for the purpose of (a), the percentage point amount is equal to 20% of the long-term gilt yield.

4.2.18 R For the purposes of *PRU 4.2.17R(1)* and (2) a *firm* must:

- (1) assume that the earnings yield for equities and the running yield for real estate fall by 10%, but the dividend yield for equities remains unaltered (see *PRU 4.2.37R* to *4.2.39R*); and
- (2) model a fall in equity and real estate markets as if the fall occurred instantaneously.

4.2.19 G An example of *PRU 4.2.17R(3)* is that, where the long-term gilt yield is currently 6%, a *firm* would assume an increase of 20% in that yield, that is, a change of 1.2 percentage points. For the purpose of the scenario in *PRU 4.2.17R(3)(a)*, the *firm* would assume a fall or rise of 1.2 percentage points in yields on all fixed interest *securities*.

EQUITY MARKET ADJUSTMENT RATIO

4.2.20 R The *equity market adjustment ratio* referred to in *PRU 4.2.17R(1)(b)* is:

- (1) if the ratio calculated in (a) and (b) lies between 75% and 100%, the result of 100% less the ratio (expressed as a percentage) of:
 - (a) the current value of the FTSE Actuaries All Share Index; to
 - (b) the average value of the FTSE Actuaries All Share Index over the preceding 90 calendar days;
- (2) 0%, if the ratio calculated in (1)(a) and (b) is more than 100%; and
- (3) 25%, if the ratio calculated in (1)(a) and (b) is less than 75%.

4.2.21 R In *PRU 4.2.20R*, the average value of the FTSE Actuaries All Share Index over any period of 90 calendar days means the arithmetic mean based on levels at the close of business on each of the days in that period on which the London Stock Exchange was open for trading.

REAL ESTATE MARKET ADJUSTMENT RATIO

4.2.22 R The *real estate market adjustment ratio* for a real estate index referred to in *PRU 4.2.17R(2)* and *PRU 4.2.24R(2)* is:

- (1) if the ratio calculated in (a) and (b) lies between 90% and 100%, the result of 100% less the ratio (expressed as a percentage) of:
 - (a) the current value of the real estate index; to
 - (b) the average value of that real estate index over the 3 preceding *financial years*;
- (2) 0%, if the ratio calculated in (1)(a) and (b) is more than 100%; and

(3) 10%, if the ratio calculated in (1)(a) and (b) is less than 90%.

- 4.2.23 G For the purpose of calculating the *real estate market adjustment ratio* in *PRU 4.2.22R*, a *firm* should select an appropriate index of real estate values such that:
- (1) the constituents of the index are reasonably representative of the nature and territory of the real estate included in the range of assets identified in accordance with *PRU 4.2.11R*; and
 - (2) the frequency of, and historical data relating to, published values of the index are sufficient to enable an average value(s) of the index to be calculated over the three preceding *financial years*.

MARKET RISK SCENARIO FOR ASSETS INVESTED OUTSIDE THE UK

- 4.2.24 R In *PRU 4.2.11R(3)(b)*, subject to *PRU 4.2.27R* the *market risk scenario* for assets invested outside the UK which a *firm* must assume is, for each significant territory in which assets are invested outside the UK:
- (1) an appropriate fall in the *market value* of equities invested in that territory, which is at least equal to the percentage fall determined in *PRU 4.2.17R*;
 - (2) a fall in real estate values in that territory of 20% less the *real estate market adjustment ratio* for an appropriate real estate index for that territory (see *PRU 4.2.22R*); and
 - (3)
 - (a) the more onerous of either a fall or a rise in yields on all fixed interest *securities* by the percentage point amount determined in (b);
 - (b) for the purpose of (a), the percentage point amount is equal to 20% of the nearest equivalent (in respect of the method of calculation) to the long term gilt yield.
- 4.2.25 R For the purposes of *PRU 4.2.24R(1)*, an appropriate fall in the *market value* of equities invested in a significant territory must be determined having regard to:
- (1) an appropriate equity market index for that territory; and
 - (2) the historical volatility of the equity market index selected in (1).
- 4.2.26 G For the purpose of *PRU 4.2.25R(1)*, an appropriate equity market index for a territory is such that:
- (1) the constituents of the index are reasonably representative of the nature of the equities held in that territory which are included in the range of assets identified in accordance with *PRU 4.2.11R*; and
 - (2) the frequency of, and historical data relating to, published values of the index are sufficient to enable an average value(s) and historical volatility of the index to be calculated over at least the three preceding *financial years*.

- 4.2.27 R** Where the assets of a *firm* invested in a significant territory of a kind referred to in *PRU 4.2.24R*(1), (2) or (3)(a) represent less than 0.5% of the *firm's long-term insurance assets*, measured by *market value*, the *firm* may assume for those assets the *market risk* scenario for assets of that kind invested in the UK set out in *PRU 4.2.17R* instead of the *market risk* scenario set out in *PRU 4.2.24R*.

Interest rate risk

INTEREST RATES: GENERAL INSURANCE LIABILITIES

- 4.2.28 G** The rates of interest to be used for the calculation of the present values of *general insurance liabilities* are specified in the *insurance accounts rules*. These state that the rate of interest to be used must not exceed the lowest of:
- (1) a rate prudently estimated by the *firm* to be earned by assets of the *firm* that are appropriate in magnitude and nature to cover the provisions for *claims* being discounted, during the period necessary for the payment of such *claims*;
 - (2) a rate justified by the performance of such assets over the preceding five years; and
 - (3) a rate justified by the performance of such assets during the year preceding the balance sheet date.

INTEREST RATES: LONG-TERM INSURANCE LIABILITIES

- 4.2.29 R** The rates of interest to be used for the calculation of the present value of a *long-term insurance liability* must not exceed 97.5% of the risk-adjusted yield (see *PRU 4.2.31R* to *PRU 4.2.51G*) that is expected to be achieved on:
- (1) the assets allocated to cover that liability;
 - (2) the reinvestment of sums expected to be received from those assets (see *PRU 4.2.48R* to *4.2.51G*); and
 - (3) the investment of future *premium* receipts (see *PRU 4.2.48R* to *4.2.51G*).
- 4.2.30 R** For the purposes of *PRU 4.2.29R*, the rates of interest assumed must allow appropriately for the rates of tax that apply to the investment return on policyholder assets. The rates of tax assumed:
- (1) must be such that the *firm's* total implied liability for tax arising from the allocation of assets to liabilities is not less than the *firm's* actual expected liability for tax for the period in respect of which tax is to be assessed; and
 - (2) for each policy, must, subject to (1), be those which apply to that *class* of business.

RISK-ADJUSTED YIELD

- 4.2.31 R A risk-adjusted yield on an asset must be calculated by:**
- (1) taking the asset together with any covering *derivatives*, forward transactions and *quasi-derivatives*;**
 - (2) assuming that the factors which affect the yield will remain unchanged after the valuation date (see *PRU 4.2.34R*);**
 - (3) valuing the asset (together with any offsetting transaction) in accordance with *PRU 1.3 (Valuation)*;**
 - (4) making reasonable assumptions as to whether, and if so when, any *options* or other rights embedded in the asset (or in any offsetting transaction) will be exercised.**
- 4.2.32 G Examples of calculating a combined yield for the purposes of *PRU 4.2.31R(1)*:**
- (1) 1000 £1 shares (fully paid) of ABC plc covered by a sold *future* on the shares. Calculating the combined yield effectively results in a position that behaves like cash (with dividend income but no capital gain or loss on the value of the assets); and
 - (2) where a covering *derivative* contains an *option* exercisable by the *firm* (e.g. a bought put *option* or receiver swaption), the calculation of the risk adjusted yield should take into account the fact that on the valuation assumptions any time value will reduce over time (known as the 'wasting' nature of the time value of the *option*), for example, an at-the money option will expire worthless and hence the covering *derivative* will effectively be a negative yielding asset. There are various ways of allowing for this, for example a *firm* could treat the covering *derivative* and the asset as a single asset and calculate an internal rate of return on this combined asset. Alternatively an explicit reserve could be set up equal and opposite to the time value of the covering *derivative* which would be written off in the same way as the time value on the covering *derivative*.
- 4.2.33 G The requirements in relation to offsetting transactions are set out in *PRU 4.3*. The *options* and other rights referred to in *PRU 4.2.31R(4)* include those exercisable by the *firm* as well as those exercisable by other parties.**
- 4.2.34 R For the purpose of *PRU 4.2.31R(2)*, the factors that affect yield should be ascertained as at the valuation date (that is, the date to which present values of cash flows are being calculated). All changes known to have occurred by that date must be taken into account including:**
- (1) changes in the rental income from real estate;**
 - (2) changes in dividends or audited profit on equities;**
 - (3) known or forecast changes in dividends which have been publicly announced by the issuer by the valuation date;**
 - (4) known or forecast changes in earnings yield which have been publicly announced by the issuer by the valuation date;**

- (5) alterations in capital structure; and
- (6) the value (at the most recent date at or before the valuation date for which it is known) of any determinant of the amount of any future interest or capital payment.

4.2.35 R The risk-adjusted yield is either:

- (1) (for equities and real estate) a running yield (see *PRU 4.2.37R* to *PRU 4.2.39R*, *PRU 4.2.42R* and *PRU 4.2.47R*); or
- (2) (for all other assets) the internal rate of return (see *PRU 4.2.40R*, *PRU 4.2.42R* and *PRU 4.2.47R*).

4.2.36 R The risk-adjusted yield on a basket of assets is the arithmetic mean of the risk-adjusted yield on each asset weighted by that asset's *market value*.

THE RUNNING YIELD FOR REAL ESTATE

4.2.37 R For real estate the running yield is the ratio of:

- (1) the rental income arising from the real estate over the previous 12 months; to
- (2) the *market value* of the real estate.

THE RUNNING YIELD FOR EQUITIES

4.2.38 R For equities the running yield is:

- (1) the dividend yield, if the dividend yield is more than the earnings yield;
- (2) otherwise, the sum of the dividend yield and the earnings yield, divided by two.

4.2.39 R For the purposes of *PRU 4.2.38R*:

- (1) the dividend yield is the ratio (expressed as a percentage) of dividend income over the previous 12 months from the equities for which the running yield is being calculated ("the relevant equities") to the *market value* of those equities;
- (2) the earnings yield is the ratio (expressed as a percentage) of the audited profit (including exceptional items and extraordinary items) for the preceding *financial year* of the issuer of the relevant equities to the *market value* of those equities;

- (3) the earnings yield must be calculated in accordance with whichever is most appropriate (to the issuer of the relevant equities) of UK, US or international generally accepted accounting practice.

THE INTERNAL RATE OF RETURN

4.2.40 R The internal rate of return on an asset is the annual rate of interest which, if used to calculate the present value of future income (before deduction of tax) and of repayments of capital (before deduction of tax) would result in the sum of those amounts being equal to the *market value* of the asset.

4.2.41 G The risk adjusted yield for a *collective investment scheme* may be determined as the weighted average of the yields on each of the investments held by the *collective investment scheme*.

CREDIT AND LIQUIDITY RISK

4.2.42 R In both the running yield and internal rate of return the yield must be reduced to exclude that part of the yield that represents compensation for credit risk and *liquidity risk* arising from the asset.

4.2.43 G The excess gross redemption yield of fixed interest *securities* over that of equivalent risk-free *securities* may be assumed to be made up of a margin for *liquidity risk* and credit risk. If a *firm* intends to hold such fixed interest *securities* through to maturity then it may be appropriate to take full credit for the margin for *liquidity risk*. If this is not the case then no credit should be taken.

4.2.44 G An example of reducing the risk-adjusted yield for the purposes of *PRU* 4.2.42R:

Bond A yield = 6.5% (will be held to maturity)

Bond B yield = 6.5% (will not be held to maturity)

Risk free rate = 5%

Expected margin for default for both Bond A and Bond B = 0.5%

Assumed yield for Bond A = 6% (i.e. bond yield - credit risk)

Assumed yield for Bond B = 5% (i.e. bond yield - (credit risk + *liquidity risk*)).

4.2.45 G An allowance for credit risk should be made for all *securities* except risk-free *securities*.

4.2.46 G Provision for credit risk for credit-rated *securities* may be made by reference to historic default rates of *securities* with a similar credit rating. However, allowance should be made both for any recent or expected changes in market conditions that may invalidate historic default rates and for the likelihood that the credit ratings on *securities* may deteriorate or (following such deterioration) that the issuer may default.

4.2.47 R Provision for credit risk for *securities* that are not credit-rated must be made on principles at least as prudent as those adopted for credit-rated *securities*.

INVESTMENT AND REINVESTMENT

- 4.2.48 R For a *realistic basis life firm*, the risk-adjusted yield (see *PRU 4.2.29R(2) and (3)*) assumed for the investment or reinvestment of sums denominated in sterling must not be more than rates derived from the forward gilts yield.
- 4.2.49 R (1) For a *regulatory basis only life firm*, the risk-adjusted yield assumed for the investment or reinvestment of sterling sums (other than sums expected to be received within the next three years) must not exceed the lowest of:
- (a) the long-term gilt yield;
 - (b) 3% per annum, increased by two thirds of the excess, if any, of the long-term gilt yield over 3% per annum; and
 - (c) 6.5% per annum.
- (2) The risk-adjusted yield assumed for the investment or reinvestment of those sterling sums expected to be received within the next three years, must not exceed the risk-adjusted yield on the assets actually held adjusted linearly over the three-year period to the risk-adjusted yield determined under (1).
- 4.2.50 R The risk-adjusted yield assumed for the investment or reinvestment of non-sterling sums must be at least as prudent as in *PRU 4.2.48R* and *PRU 4.2.49R*.
- 4.2.51 G The purpose of *PRU 4.2.48R* to *PRU 4.2.50R* is to help protect against 'reinvestment risk'. Reinvestment risk is the risk that, when the sums are actually received, interest rates (and so yields available on assets) might have fallen below current expectations.

Currency risk

SOURCES OF CURRENCY RISK

- 4.2.52 G Fluctuations in foreign exchange rates may impact adversely upon a *firm*, including where it holds an open position in a foreign currency. This is where future cash outflows (that is liabilities) in one currency are matched by future cash inflows (that is assets) in a different currency. The circumstances in which this could arise include where the *firm*:
- (1) has entered into contracts for the purchase or sale of foreign currency;
 - (2) has entered into *contracts of insurance* under which *claims* are payable in, or determined by reference to a value or price expressed in, a foreign currency; or
 - (3) holds assets denominated in a foreign currency.

COVER FOR SPOT AND FORWARD CURRENCY TRANSACTIONS

- 4.2.53 R A *firm* must cover a contract providing for the purchase or sale of foreign currency by:

- (1) holding the currency that must be paid by the *firm* under the contract; or
- (2) being subject to an offsetting transaction.

4.2.54 G The requirements in relation to cover and offsetting transactions are set out in *PRU* 4.3.

CURRENCY MATCHING OF ASSETS AND LIABILITIES

4.2.55 G *PRU* 7.2.35R requires a *firm* to cover its liabilities with assets that enable it to match, in timing, amount and currency, the cash inflows and outflows from those assets and liabilities. This permits some currency mismatching of assets and liabilities, but only if sufficient excess assets are held to cover the exposure arising from such mismatching. The level of permitted currency mismatching is also limited by *PRU* 4.2.56R.

4.2.56 R Subject to *PRU* 4.2.57R, a *firm* must hold *admissible assets* in each currency of an amount equal to at least 80% of the amount of its liabilities (excluding, for a *firm* that carries on *general insurance business*, any *equalisation provision*) in that currency, except where the amount of those assets does not exceed 7% of the assets in other currencies.

4.2.57 R *PRU* 4.2.56R does not apply to:

- (1) a *pure reinsurer*;
- (2) assets held to cover *index-linked liabilities* or *property-linked liabilities*.

4.2.58 R For the purpose of *PRU* 4.2.56R, the currency of the liability under a *contract of insurance* is the currency in which the cover under the *contract of insurance* is expressed or, if the contract does not specify a currency:

- (1) the currency of the country or territory in which the risk is situated; or
- (2) if the *firm* on reasonable grounds so decides, the currency in which the *premium* payable under the contract is expressed; or
- (3) if, taking into account the nature of the risks insured, the *firm* considers it more appropriate:
 - (a) the currency (based on past experience) in which it expects the *claims* to be paid; or
 - (b) if there is no past experience, the currency of the country or territory in which the *firm* or relevant branch is established:
 - (i) for contracts covering risks falling within *general insurance business classes 4, 5, 6, 7, 11, 12 and 13* (producer's liability only); and

(ii) for contracts covering risks falling within any other *general business class* where, in accordance with the nature of the risks, the *firm's* liabilities are liabilities to be provided in a currency other than that which would result from the application of (1) or (2); or

(4) (where a *claim* has been notified to the *firm* and the *firm's* liability in respect of that *claim* is payable in a currency other than that which would result from the application of (1), (2) or (3)) the currency in which the *claim* is to be paid; or

(5) (where a *claim* is assessed in a currency known to the *firm* in advance and is a currency other than that which would result from the application of (1), (2), (3) or (4)) the currency in which the *claim* is to be assessed.

4.2.59 G The reasonable grounds in 4.2.58R(2) include if, from the time the contract is entered into, it appears likely that a *claim* will be paid in the currency of the *premium* and not in the currency of the country in which the risk is situated.

Covering linked liabilities

4.2.60 R A *firm* must cover its *property-linked liabilities* with:

- (1) (as closely as possible) the assets to which those liabilities are linked; or
- (2) a property-linked *reinsurance* contract; or
- (3) a combination of (1) and (2).

4.2.61 R A *firm* must cover its *index-linked liabilities* with:

- (1) either:
 - (a) the assets which represent that index; or
 - (b) assets of appropriate security and marketability which correspond, as closely as possible, to the assets which are comprised in, or which form, the index or other reference of value to which those liabilities are linked; or
- (2) a portfolio of assets whose value or yield is reasonably expected to correspond closely with the *index-linked liability*; or
- (3) an index-linked *reinsurance* contract; or
- (4) an index-linked *approved derivative*; or
- (5) an index-linked *approved quasi-derivative*; or
- (6) a combination of any of (1) to (5).

- 4.2.62 G For the purposes of *PRU 4.2.60R* and *PRU 4.2.61R* a *firm* is not permitted to hold different assets and to cover the mismatch by holding excess assets.
- 4.2.63 G If a *firm* has incurred a policy liability which cannot be exactly matched by appropriate assets (for example the Limited Price Index (LPI) and Earnings Index) then the *firm* should seek to match assets that at least cover the liabilities. For example, an LPI limited to 5% per annum may be matched by a 5% fixed interest bond or a RPI bond.
- 4.2.64 G In selecting the appropriate cover, the *firm* should ensure that both credit risk, and the risk that the value or yield in the assets will not, in all circumstances, match fluctuations in the relevant index, are within acceptable limits. *Rules* and *guidance* relating to credit risk are set out in *PRU 3.2*.

4.3 Derivatives in insurance

Application

- 4.3.1 R This section applies to *insurers*, referred to as *firms* in this section.
- 4.3.2 R This section does not apply to a *firm* which is:
- (1) a *non-directive friendly society*; or
 - (2) an *incoming EEA firm*; or
 - (3) an *incoming Treaty firm*.
- 4.3.3 G The scope of application of PRU 4.3 is not restricted to *firms* that are subject to the relevant EC directives. It applies, for example, to *pure reinsurers*.
- 4.3.4 (1) This section applies to a *firm* in relation to the whole of its business, except where a particular provision provides for a narrower scope.
- (2) Where a *firm* carries on both *long-term insurance business* and *general insurance business*, this section applies separately to each type of business.

Purpose

- 4.3.5 G PRU 2.2.12R requires a *firm* to calculate its *capital resources* for the purpose of PRU in accordance with Table PRU 2.2.14R, subject to the limits in PRU 2.2.16R to PRU 2.2.23R. Table PRU 2.2.14R and PRU 2.2.86R require a *firm* to deduct from *tier one capital resources* the value of any asset included in an insurance fund which is not an *admissible asset* as listed in PRU 2.2 Annex 1R. PRU 2.2 Annex 1R provides that a *derivative*, *quasi-derivative* or *stock lending transaction* will only be an *admissible asset* if it is approved. This section sets out the criteria for determining when a *derivative*, *quasi-derivative* or *stock lending transaction* is approved for this purpose. PRU 4.3.6R to PRU 4.3.36R set out the criteria for *derivatives* and *quasi-derivatives*. PRU 4.3.37R to PRU 4.3.42R set out the criteria for *stock lending transactions*.

Derivatives and quasi-derivatives

- 4.3.6 R For the purpose of PRU 2.2 Annex 1R (Admissible assets in insurance funds) a *derivative* or *quasi-derivative* is approved if:
- (1) it is held for the purpose of efficient portfolio management (PRU 4.3.7R to 4.3.8R) or reduction of investment risk (PRU 4.3.9R to 4.3.14G);
 - (2) it is covered (PRU 4.3.15R to 4.3.34G); and
 - (3) it is effected:

- (a) on or under the *rules of a regulated market*; or
- (b) off-market with an *approved counterparty* and, except for a forward transaction, on approved terms and is capable of valuation (*PRU 4.3.35R to 4.3.36R*).

Efficient portfolio management

- 4.3.7 R** A *derivative* or *quasi-derivative* is held for the purpose of efficient portfolio management if the *firm* reasonably believes the *derivative* or *quasi-derivative* (either alone or together with any other covered transactions) enables the *firm* to achieve its investment objectives by one of the following:
- (1) generating additional capital or income in one of the ways described in *PRU 4.3.8R*; or
 - (2) reducing tax or investment cost in relation to *admissible assets*; or
 - (3) acquiring or disposing of rights in relation to *admissible assets*, or their equivalent, more efficiently or effectively.

GENERATION OF ADDITIONAL CAPITAL OR INCOME

- 4.3.8 R** The generation of additional capital or income falls within *PRU 4.3.7R(1)* where it arises from:
- (1) taking advantage of pricing imperfections in relation to the acquisition and disposal (or disposal and acquisition) of rights in relation to assets the same as, or equivalent to, *admissible assets*; or
 - (2) receiving a premium for selling a covered call *option* or its equivalent, the underlying of which is an *admissible asset*, even if that additional capital or income is obtained at the expense of surrendering the chance of greater capital or income.

Reduction of investment risk

- 4.3.9 R** A *derivative* or *quasi-derivative* is held for the purpose of reducing investment risk if the *derivative* or *quasi-derivative* (either alone or together with other fully covered transactions) reduces any aspect of investment risk without significantly increasing any other aspect of that risk.

SIGNIFICANT INCREASE IN RISK

- 4.3.10 R** For the purposes of *PRU 4.3.9R*, an increase in risk from a *derivative* or *quasi-derivative* is significant unless:

- (1) **relative to any reduction in investment risk it is both small and reasonable; or**
- (2) **the risk is remote.**

- 4.3.11 G *PRU 4.3.9R* does not require that a *derivative* or *quasi-derivative* has no possible adverse consequences. Often a *derivative* or *quasi-derivative* is effected to protect against a severe adverse consequence that only arises in one circumstance. In all other circumstances it may itself lead to adverse consequences, even if only because it expires worthless resulting in the loss of the purchase price. Conversely a *derivative* or *quasi-derivative* may reduce risk in a wide range of circumstances but lead to adverse consequences when a particular circumstance arises, e.g. the default of the *counterparty*. Only rarely does a *derivative* or *quasi-derivative* give rise to no adverse consequences in any circumstances. The test is merely that the increase in risk should not be significant, that is it should be both small and reasonable, or the risk should be remote.
- 4.3.12 G *Firms* are reminded that *PRU 3.2* (Credit risk in insurance) sets out the different types of loss mitigation techniques.

INVESTMENT RISK

- 4.3.13 R **For the purposes of *PRU 4.3.9R*, investment risk is the risk that the *admissible assets* held by a *firm* to cover its *technical provisions*:**
- (1) **might not be:**
 - (a) **of a value at least equal to the amount of those *technical provisions* as required by *PRU 7.2.21R*; or**
 - (b) **of appropriate safety, yield and marketability as required by *PRU 7.2.35R(1)(a)*; or**
 - (c) **of an appropriate currency match as required by *PRU 4.2.56R*.**
 - (2) **(where they are held to cover *index-linked liabilities*) might not be appropriate cover for those liabilities as required by *PRU 4.2.61R*; and**
 - (3) **(where they are held to cover *property-linked liabilities*) might not be appropriately selected in accordance with contractual and constructive liabilities as required by *PRU 7.6.33R* and appropriate cover for those liabilities as required by *PRU 4.2.60R*.**
- 4.3.14 G In assessing whether investment risk is reduced, the impact of a transaction on both the assets and liabilities should be considered. In particular, where the amount of liabilities depends upon the fluctuations in an index or other factor, investment risk is reduced where assets whose value fluctuates in the same way match those liabilities. In appropriate circumstances this may include:
- (1) a *derivative* or *quasi-derivative* that is linked to the same index as the liabilities from the index-linked contracts; and
 - (2) a *derivative* or *quasi-derivative* whose value depends upon the factors which give rise to general insurance claims, e.g. a weather *quasi-derivative*.

Cover

- 4.3.15 R** A *firm* must cover an obligation to transfer assets or pay monetary amounts that arises from:
- (1) a *derivative* or *quasi-derivative*; or
 - (2) a contract (other than a *contract of insurance*) for the purchase, sale or exchange of assets.
- 4.3.16 R** An obligation to transfer assets or pay monetary amounts (see *PRU 4.3.15R*) must be covered:
- (1) by assets, a liability or a provision (see *PRU 4.3.17R* to *4.3.25R*); or
 - (2) by an offsetting transaction (*PRU 4.3.26R* to *28R*).
- 4.3.17 R** An obligation to transfer assets (other than *money*) or to pay monetary amounts based on the value of, or income from, assets is covered if the *firm* holds:
- (1) those assets; or
 - (2) in the case of an index or basket of assets, a reasonable approximation to those assets.
- 4.3.18 R** An obligation to pay a monetary amount (whether or not falling in *PRU 4.3.17R*) is covered if:
- (1) the *firm* holds *admissible assets* that are sufficient in value so that the *firm* reasonably believes that following reasonably foreseeable adverse variations (relying solely on cashflows from, or from realising, those assets) it could pay the monetary amount in the right currency when it falls due; or
 - (2) the obligation to pay the monetary amount is offset by a liability. An obligation is offset by a liability where an increase in the amount of that obligation would be offset by a decrease in the amount of that liability; or
 - (3) a provision at least equal to the value of the assets in (1) is implicitly or explicitly set up. A provision is implicitly set up to the extent that the obligation to pay the monetary amount is recognised under *PRU 1.3* (Valuation) either by offset against an asset or as a separate liability. A provision is explicitly set up if it is in addition to an implicit provision.
- 4.3.19 R** A firm must implicitly or explicitly set up a provision equal to the value of the assets or offsetting transactions held to cover a non-approved *derivative* or *quasi-derivative* transaction.

- 4.3.20 G Where a *firm* partially covers a *derivative* (or other contract falling within PRU 4.3.15R(1) and (2)), the *firm* may split the *derivative* into a covered portion and an uncovered portion. The portion of the *derivative* that is covered (after taking into account the requirement to cover reasonably foreseeable adverse variations in PRU 4.3.18R(1)) is an approved *derivative*, provided it also meets the requirements in PRU 4.3.6R(1) and (3); the uncovered portion is not an approved *derivative*.
- 4.3.21 G Exposure to a transaction includes exposure that arises from a right at the *firm's* (or its *subsidiary undertakings*) option to dispose of assets.
- 4.3.22 G Cover serves three purposes. First it protects against exposure to loss from the transaction which is being covered. The value of the cover increases (or if the cover is a liability the amount of that liability decreases) to match any increase in obligations under the transaction.
- 4.3.23 G The second purpose of cover is that it prevents excessive gearing in the investment portfolio by the use of *options* and their equivalent. A *firm* is required to cover all obligations under an admissible transaction including obligations that would arise only at the option of the insurer, e.g. the liability to pay the exercise price under a bought *option*.
- 4.3.24 G The third purpose of cover is that it protects against the risk that the *firm* may not be able to deliver assets (including *money* in any currency) of the right type when the obligation falls due under the transaction. An obligation to deliver assets is covered only if the *firm* holds those assets or has entered into an offsetting transaction that would deliver those assets when needed. An obligation to pay *money* is offset only if the *firm* holds cash in the right currency, its equivalent or assets that could reliably be converted into cash in the right currency.
- 4.3.25 R Cover used for one transaction must not be used for cover in respect of another transaction or any other agreement to acquire, or dispose of, assets or to pay or repay money.**

OFFSETTING TRANSACTIONS

- 4.3.26 R An offsetting transaction means:**
- (1) an approved derivative, approved stock lending transaction or an approved quasi-derivative; or**
 - (2) a covered transaction with an approved counterparty for the purchase of assets.**
- 4.3.27 R A transaction offsets an obligation to transfer assets away from the firm only if it provides for the transfer to the firm of those assets, or their value, at the time, or before, the obligation falls due.**
- 4.3.28 R A transaction offsets an obligation to pay a monetary amount only if it provides for that monetary amount to be paid to the firm at or before the earliest date on which the obligation might fall due.**

LENDING AND BORROWING ASSETS

- 4.3.29 R Assets that have been lent by the firm are not available for cover, unless:**

- (1) they are non-monetary assets that have been lent under a transaction that fulfils the conditions in *PRU 4.3.37R*; and
- (2) the *firm* reasonably believes the assets to be obtainable (by return or re-acquisition) in time to meet the obligation for which cover is required.

4.3.30 R Assets that have been borrowed by the *firm* are not available for cover except as allowed by *PRU 4.3.31R*.

4.3.31 R Borrowed *money* may be used as cover only where:

- (1) the *money* has been advanced or an *approved credit institution* has committed itself to advance the *money*; and
- (2) the borrowing is or would be covered.

4.3.32 G *PRU 4.3.31R* in effect allows borrowings to be used to bridge the gap between an obligation under a transaction that might fall due at one date and cash or its equivalent that would only become due at a later date. Borrowings may not be used to gear the investment portfolio.

EXAMPLES OF COVER REQUIREMENTS

4.3.33 G Examples of cover by assets for the purposes of *PRU 4.3.18R* :

- (1) a bought put *option* (or a sold call *option*) on 1000 £1 shares (fully paid) of ABC plc is covered by an existing holding in the fund of 1000 £1 shares (fully paid) of ABC plc;
- (2) a bought call *option* (or sold put *option*) on 1000 ordinary £1 shares (fully paid) of ABC plc is covered by cash (or its equivalent) which is sufficient in amount to meet the purchase price of the shares on exercise of the *option*;
- (3) a bought or sold *contract for differences* on short-dated sterling is covered by cash (or its equivalent), the value of which together at least match the notional principal of the contract. For example, a LIFFE short sterling contract, or a successive series of such contracts, is covered by £500,000; and
- (4) a sold *future* on the FT-SE 100 index is covered by holdings of equities, which satisfy the reasonable approximation test for cover in *PRU 4.3.18R(2)* in relation to that *future*, and the values of which together at least match the current mark to market valuation of the *future*. For example, if the multiplier per full point is £10, and if the eventual obligation under the *future* is currently 2800, the valuation of the *futures* position is $2800 \times £10 = £28,000$.

4.3.34 G Examples of cover by offsetting transactions for the purpose of *PRU 4.3.26R* would include a bought *future* which is guaranteed to deliver to the *firm* at the relevant time sufficient assets to cover liabilities under a sold call *option*.

Over the counter transactions

4.3.35 R For the purpose of *PRU 4.3.6R(3)(b)* a transaction is on approved terms only if the *counterparty* has agreed to enter into a further transaction to close out the first transaction at a market price.

- 4.3.36 R A transaction is capable of valuation only if the *firm*, throughout the life of the transaction, will be able to value it with reasonable accuracy on a reliable basis reflecting an up-to-date mark-to-market value.

Stock lending

- 4.3.37 R For the purposes of *PRU 2.2 Annex 1R* (Admissible assets in insurance funds), a *stock lending* transaction is approved if:
- (1) the assets lent are *admissible assets*;
 - (2) the *counterparty* is an *authorised person* or an *approved counterparty*; and
 - (3) adequate and sufficiently immediate *collateral* (*PRU 4.3.39R* to *42R*) is obtained to secure the obligation of the *counterparty*.
- 4.3.38 G *PRU 4.3.37R* refers only to *stock lending* transactions where the *firm* is the lender. There are no special rules for a transaction under which the firm borrows securities.

COLLATERAL

- 4.3.39 R For the purposes of *PRU 4.3.37R(3)*, *collateral* is adequate only if it:
- (1) is transferred to the *firm* or its agent;
 - (2) is at the time of the transfer, at least equal in value, to the value of the *securities* transferred, or consideration provided, by the *firm*; and
 - (3) is of adequate quality.
- 4.3.40 G For the purposes of assessing adequate quality in *PRU 4.3.37R(3)* reference should be made to the criteria for credit risk loss mitigation set out in *PRU 3.2.19R*. The valuation rules in *PRU 1.3.6R* apply for the purpose of determining the value of both *collateral* received and the *securities* transferred. In addition, *collateral* that is not an *admissible asset* does not have a value (see *PRU 2.2, Annex 1*).
- 4.3.41 R For the purposes of *PRU 4.3.37R(3)*, *collateral* is sufficiently immediate only if:
- (1) it is transferred before, or at the same time as the transfer of the *securities* by the *firm*; or
 - (2) it will be transferred, at latest, by the close of business on the day of the transfer.
- 4.3.42 R *Collateral* continues to be adequate only if its value is at all times at least equal to the value of the *securities* transferred by the *firm*. This will be satisfied in respect of *collateral* the validity of which is about to expire or has expired where sufficient *collateral* will again be transferred at the latest by the close of business on the day of expiry.

7.2 Capital resources requirements and technical provisions for insurance business

Application

- 7.2.1 R** This section applies to *insurers*, referred to as *firms* in this section.
- 7.2.2 R** This section does not apply to a *firm* which is:
- (1) a *non-directive friendly society*; or
 - (2) an *incoming EEA firm*; or
 - (3) an *incoming Treaty firm*.
- 7.2.3 R** (1) This section applies to a *firm* in relation to the whole of its business, except where a particular provision provides for a narrower scope.
- (2) Where a *firm* carries on both *long-term insurance business* and *general insurance business*, this section applies separately to each type of business.
- 7.2.4 R** For a *firm* which is a *non-EEA direct insurer* with a *branch* in the *United Kingdom*, the part of this section headed “Capital requirements for insurers” (*PRU 7.2.44G to 92R*) applies to its world-wide activities, whilst the parts of this section headed “Establishing technical provisions” (*PRU 7.2.13R to 20G*), “Assets of a value sufficient to cover technical provisions” (*PRU 7.2.21R to 30G*), “Matching of assets and liabilities” (*PRU 7.2.35R to 41G*) and “Premiums for new business” (*PRU 7.2.42R to 43G*) apply in respect of its activities carried on from a *branch* in the *United Kingdom*. The part of this section headed “Localisation” (*PRU 7.2.31R to 34R*) does not apply (see *PRU 7.6* (Internal contagion risk)).
- 7.2.5 R** For a *firm* which is an *EEA-deposit insurer* or a *Swiss general insurer*, the parts of this section headed “Establishing technical provisions” (*PRU 7.2.13R to 20G*), “Assets of a value sufficient to cover technical provisions” (*PRU 7.2.21R to 30G*), “Matching of assets and liabilities” (*PRU 7.2.35R to 41G*) and “Premiums for new business” (*PRU 7.2.42R to 43G*) apply in respect of the activities of the *firm* carried on from a *branch* in the *United Kingdom*. The parts of this section headed “Capital requirements for insurers” (*PRU 7.2.44G to 92R*) and “Localisation” (*PRU 7.2.31R to 34R*) do not apply.

- 7.2.6 R For a *firm* which is an *UK-deposit insurer*, the part of this section headed “Capital requirements for insurers” (PRU 7.2.44G to 92R) applies to its world-wide activities, whilst the parts of this section headed “Establishing technical provisions” (PRU 7.2.13R to 20G), “Assets of a value sufficient to cover technical provisions” (PRU 7.2.21R to 30G), “Matching of assets and liabilities” (PRU 7.2.35R to 41G) and “Premiums for new business” (PRU 7.2.42R to 43G) apply in respect of the activities of the *firm* carried on from *branches* in *EEA States*. The part of this section headed “Localisation” (PRU 7.2.31R to 34R) does not apply (see PRU 7.6 (Internal contagion risk)).
- 7.2.7 G This section may apply in cases where a *firm* has its head office in another *EEA State* but is neither an *incoming EEA firm* nor an *incoming Treaty firm*; this could arise in the case of (i) a *mutual* that is a *non-Directive insurer* or (ii) a *pure reinsurer*.

Purpose

- 7.2.8 G PRU 7.2 has the aim of reducing the risk that a *firm* may fail to meet its liabilities to its policyholders as a result of insurance risk, that is, the risk that arises from the inherent uncertainties as to the occurrence, amount and timing of insurance liabilities.
- 7.2.9 G This section requires that the *technical provisions* that *firms* establish are adequate to meet their liabilities to *policyholders* under contracts of insurance. It also requires that *firms* hold assets of a value sufficient to cover their liabilities, including *technical provisions*, and that there is suitable matching of assets and liabilities. *Technical provisions* are the on-balance sheet provisions made by a *firm* in respect of liabilities arising under or in connection with contracts of insurance. There are different *rules* and *guidance* applicable to the calculation of *technical provisions* for *general insurance business* and for *long-term insurance business*.
- 7.2.10 G This section implements requirements of the *Insurance Directives* for both *general insurance business* and *long-term insurance business* with regard to the *technical provisions*. The relevant Articles of the Directives include:
- article 15 of the *First Non-Life Directive*, as substituted by article 17 of the *Third Non-Life Directive*; and
 - article 20 of the *Life Assurance Directive* (this Directive consolidates the provisions of the previous *First*, *Second* and *Third Life Directives*).
- 7.2.11 G This section also sets out detailed *rules* and *guidance* on the calculation of the following elements of a *firm's capital resources requirement (CRR)* (see PRU 2.1):
- (1) the *general insurance capital requirement*; and
 - (2) the *long-term insurance capital requirement*.
- 7.2.12 G These requirements are dealt with in the part of this section headed “Capital requirements for insurers” (see PRU 7.2.44G to 92R). That part of this section also contains *rules* about the calculation of the *insurance-related capital requirement*, which forms part of the *enhanced capital requirement* for *firms* carrying on *general insurance business*. The *asset-related capital requirement* for *firms* carrying on *general insurance business* is set out in PRU 3.3.

Establishing technical provisions

- 7.2.13 R For general insurance business, a firm must establish adequate technical provisions:**
- (1) in accordance with the rules in PRU 7.5 for equalisation provisions; and**
 - (2) otherwise, in accordance with PRU 1.3.6R.**
- 7.2.14 G For *general insurance business* the *technical provisions* include outstanding claims provisions, *unearned premiums* provisions, unexpired risk provisions and *equalisation provisions*. These provisions take into account the expected ultimate cost of *claims*, including those not yet incurred, related expenses and include an allowance for smoothing claims (the *equalisation provision*).
- 7.2.15 G *Discounting* (that is discounting for the time value of money) *general insurance business technical provisions* may be carried out only in limited circumstances and on a prudent basis (see PRU 2.2.80R and 2.2.81R and paragraph 48 of the *insurance accounts rules*). The fact that the expected liabilities are generally not *discounted* helps to protect against risk from inherent uncertainty in the timing, but not necessarily the amount, of *claims*.
- 7.2.16 G For some categories of *general insurance business*, *equalisation provisions* are required. These ensure that a *firm* retains additional assets to provide some extra protection against uncertainty as to the amount of *claims*. *Equalisation provisions* are particularly suitable for volatile business, where *claims* in any future year may be subject to significant adverse deviation from recent or average expected *claims* experience, or where trends in *claims* experience may be subject to change. Such volatile claims experience arises in a number of types of business, for example property, marine and aviation, nuclear, certain *non-proportional reinsurance treaty* business, and credit insurance. The *equalisation provisions* help to equalise fluctuations in loss ratios in future years. See PRU 7.5 (*Equalisation provisions*).
- 7.2.17 R For long-term insurance business, a firm must establish adequate technical provisions:**
- (1) for its long-term insurance contracts, in accordance with the rules and guidance in PRU 7.3 relating to mathematical reserves, and with due regard to generally accepted actuarial best practice; and**
 - (2) for long-term insurance liabilities which have fallen due, in accordance with PRU 1.3.6R.**
- 7.2.18 G *Rules and guidance* for calculating *mathematical reserves* are set out in PRU 7.3. *Firms* are advised by the *actuarial function* (see SUP 4) on the methods and assumptions to be used in calculating the *mathematical reserves*. The standards and guidance issued by the Faculty and Institute of Actuaries to assist actuaries appointed to the *actuarial function* are important sources of evidence as to generally accepted actuarial best practice, as referred to in PRU 7.2.17R(1).
- 7.2.19 G For *long-term insurance business* the *technical provisions* include the *mathematical reserves*. These are actuarial estimates of a *firm's* liabilities in respect of future benefits due to *policyholders*, including bonuses already declared. The *mathematical reserves* may be reduced by the actuarial value of that component of future *premiums* attributable to meeting future liabilities. See PRU 7.3 (*Mathematical reserves*).

PRU 7.2 Capital resources requirements and technical provisions for insurance business

- 7.2.20 G For *long-term insurance business* the *mathematical reserves* are typically valued on a *discounted* basis but include valuation margins intended to provide protection against adverse deviations in experience (see *PRU 7.3*).

Assets of a value sufficient to cover technical provisions

- 7.2.21 R A *firm* must hold *admissible assets* of a value at least equal to the amount of the *technical provisions* that it is required to establish under *PRU 7.2.13R* and *7.2.17R*.
- 7.2.22 R A *composite firm* must ensure that:
- (1) its separately identified *long-term insurance assets* have a value at least equal to the amount of:
 - (a) its *technical provisions for long-term insurance liabilities*; and
 - (b) any other liabilities connected with *long-term insurance business*; and
 - (2) that it has other *admissible assets* of a value at least equal to the amount of its *technical provisions for general insurance liabilities*.
- 7.2.23 G *PRU 7.6* (Internal-contagion risk) sets out the *rules* and *guidance* on identifying and holding in a separate fund *long-term insurance assets*.
- 7.2.24 G When valuing assets for the purposes of *PRU 7.2.21R* and *7.2.22R* a *firm* should bear in mind:
- (1) that the *technical provisions* should be covered by *admissible assets* (see *PRU 2.2*, Annex 1R); and
 - (2) that the market and counterparty limits set out in *PRU 3.2* (Credit risk in insurance) result in the attribution of no value to that proportion of any asset holding that exceeds the specified limits. *PRU 3.2* requires that a *firm* restrict to prudent levels its exposure to reinsurer and other counterparties, and, in particular, that for the purpose of its balance sheet a *firm* must not take into account any exposure which exceeds the large exposure limits.
- 7.2.25 G *Rules* and *guidance* on the valuation of assets are set out in *PRU 1.3* (Valuation), including the treatment of shares in, and debts due from, related undertakings in *PRU 1.3.32R* to *1.3.42G*. *PRU 4.2* (Market risk in insurance) addresses market risk and sets out the matching requirements for linked assets and liabilities. *PRU 4.2* also sets out *rules* and *guidance* on the matching by currency of assets and liabilities, to reduce a *firm's* exposure to currency market risk.
- 7.2.26 R For the purpose of determining the value of assets available to meet *long-term insurance liabilities* in accordance with *PRU 7.2.21R* and *7.2.22R*, no value is to be attributed to debts and claims other than in respect of:
- (1) amounts that have already fallen due;

(2) tax recoveries and claims against *guarantee funds* to the extent not already offset in *mathematical reserves*.

- 7.2.27 G Certain debts and claims are excluded from *PRU 7.2.21R* and *7.2.22R* to avoid double-counting. The *rules* and *guidance* in *PRU 7.3 (Mathematical reserves)* set out how a *firm* may offset debts and claims against liabilities in calculating the *mathematical reserves* required for *long-term insurance business*. Tax recoveries and claims against guarantee funds in *PRU 7.2.26R(2)* are set out in the list of *admissible assets* (see *PRU 2.2, Annex 1R*).
- 7.2.28 R **A *regulatory basis only life firm* must ensure that it has *admissible assets* in each of its *with-profits funds* of a value sufficient to cover the *mathematical reserves* in respect of all the business written in that *with-profits fund*.**
- 7.2.29 R **A *realistic basis life firm* must ensure that it has *admissible assets* in each of its *with-profits funds* of a value sufficient to cover the higher of:**
- (1) the *mathematical reserves* in respect of all the business written in that *with-profits fund*; and**
 - (2) the sum of:**
 - (a) the *realistic value of liabilities* of the *with-profits fund* (as defined in *PRU 7.4.38R*);**
 - (b) the *mathematical reserves* in respect of the *non-profit insurance business* written in the *with-profits fund*;**
 - (c) the amount in respect of the *non-profit insurance contracts* written in the *with-profits fund* which represents an appropriate allocation of the *firm's long-term insurance capital requirement* (as determined under *PRU 7.4.22R*); and**
 - (d) the amount in respect of the *non-profit insurance contracts* written in the *with-profits fund* which represents an appropriate allocation of the *firm's resilience capital requirement* (as determined under *PRU 7.4.22R*),**
- less the present value of future profits in respect of the *non-profit insurance business* written in the *with-profits fund* (as determined under *PRU 7.4.36R*).**
- 7.2.30 G *PRU 7.2.29R* supports the funding of *policyholder* benefits by requiring *firms* to maintain *admissible assets* in *with-profits funds* to cover the realistic liabilities of the business in that fund, or the *mathematical reserves*, if higher.

Localisation (UK firms only)

- 7.2.31 R **(1) Subject to (2), a *UK firm* must hold *admissible assets* held pursuant to *PRU 4.2.56R*:**

- (a) (where the *admissible assets* cover *technical provisions* in pounds sterling), in any *EEA State*; and
 - (b) (where the *admissible assets* cover *technical provisions* in any currency other than pounds sterling), in any *EEA State* or in the country of that currency.
 - (2) In the case of a *relevant co-insurance operation* and a *relevant insurer*, the *admissible assets* covering *technical provisions* must be held in any *EEA State*.
- 7.2.32 G *PRU 7.6* (Internal contagion risk) sets out the *rules* and *guidance* on localisation rules for *firms* other than *UK firms*.
- 7.2.33 R ***PRU 7.2.31R* does not apply to:**
- (1) a *pure reinsurer*; or
 - (2) debts owed by reinsurers; or
 - (3) *insurance business* carried on by a *UK firm* outside the *EEA States*; or
 - (4) *classes of general insurance business* in the groups numbered 3 and 4 in IPRU(Ins), Annex 11.2, Part II.
- 7.2.34 R For the purposes of *PRU 7.2.31R*:
- (1) a tangible asset is to be treated as held in the country or territory where it is situated;
 - (2) an *admissible asset* consisting of a claim against a debtor is to be treated as held in any country or territory where it can be enforced by legal action;
 - (3) a *listed security* is to be treated as held in any country or territory where there is a *regulated market* in which the security is dealt; and
 - (4) a security which is not a *listed security* is to be treated as held in the country or territory in which the *issuer* has its head office.

Matching of assets and liabilities

- 7.2.35 R (1) Subject to (4), the assets held by a *firm* to cover its *technical provisions* (see *PRU 7.2.21R* and *7.2.22R*) must:
- (a) have characteristics of safety, yield and marketability which are appropriate to the type of business carried on by the *firm*;
 - (b) be diversified and adequately spread; and

(c) comply with (2).

- (2) The assets referred to in (1) must, in addition to meeting the criteria set out in (1)(a) and (b), be of a sufficient amount, and of an appropriate currency and term, to ensure that the cash inflows from those assets will meet the expected cash outflows from the *firm's* insurance liabilities as they become due.
- (3) For the purpose of (2), a *firm* must take into consideration in determining expected cash outflows any options which exist in the *firm's contracts of insurance*.
- (4) (1) does not apply to assets held to cover *index-linked liabilities* or *property-linked liabilities*, except that where the *linked long-term contract of insurance* in question includes a guarantee of investment performance or some other guaranteed benefit, (1) will nevertheless apply to assets held to cover that guaranteed element.

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| 7.2.36 | G | A <i>firm</i> should take account of the amount, currency and timing of its expected cash outflows in determining whether the assets it holds to cover its <i>technical provisions</i> meet the requirements of PRU 7.2.35R(2). |
| 7.2.37 | G | <p>For the purpose of PRU 7.2.35R(2), the relevant cash inflows are those which the <i>firm</i> reasonably expects to receive from the <i>admissible assets</i> which it holds to cover its <i>technical provisions</i>. A <i>firm</i> may receive cash inflows as a result of:</p> <ol style="list-style-type: none"> (1) selling assets or closing out transactions; (2) holding assets that generate dividends, interest or other income; and (3) receiving future <i>premiums</i> for existing business. |
| 7.2.38 | G | Anticipated cash inflows from future new business should not be included, for example where the customer has not yet contracted to pay the <i>premium</i> , and where the associated liabilities and potential cash outflows should also not be included. |
| 7.2.39 | G | A <i>firm</i> should compare cash inflows and outflows based on current expectations of amounts and timings. Current market expectations of future asset values, interest rates and currency exchange rates should be used. Where inflows are received in a currency different from that in which outflows are to be paid, account should be taken of the cost of converting the currency received. |
| 7.2.40 | G | In considering the value and suitability of assets required to ensure that the <i>firm's</i> liabilities are met as they become due, a <i>firm</i> should take account of the risk of default on inflows from those assets, and other risks that may mean that future inflows are reduced relative to outflows. |
| 7.2.41 | G | PRU 7.2.21R lays down a general requirement for a <i>firm</i> that carries on <i>long-term insurance business</i> to hold admissible assets that are of a value sufficient to cover its <i>mathematical reserves</i> (calculated in accordance with the <i>rules</i> in PRU 7.3). The PRU 7.2.35R(2) requirement to match liabilities with assets that allow cash outflows to be met with suitable inflows as the outflows become due may mean that a <i>firm</i> has to hold assets of a value greater than would otherwise be required by the general <i>rule</i> in PRU 7.2.21R. |

Premiums for new business

- 7.2.42 R** A *firm* must not enter into a *long-term insurance contract* unless it is satisfied on reasonable actuarial assumptions that:
- (1) the *premiums* receivable and the investment income expected to be earned from those *premiums*; and
 - (2) the *reinsurance* arrangements made in respect of the risk or risks covered by that new contract;
- are sufficient to enable it, when taken together with the *firm's* other resources, to:
- (a) establish adequate *technical provisions* as required by *PRU 7.2.13R to 20G*;
 - (b) hold *admissible assets* of a value at least equal to the amount of the *technical provisions* as required by *PRU 7.2.21R to 30G*; and
 - (c) maintain adequate overall financial resources as required by *PRU 1.2.22R*.
- 7.2.43 G** For the purposes of *PRU 7.2.42R*, the adequacy of *premiums* may be assessed in the context of a *firm's* total portfolio of business and its other resources. It thus does not prevent a *firm* writing loss leaders nor writing contracts which might incur large losses, but only if the *firm* can meet the losses that might reasonably arise, including those that would arise from an event specifically insured against.

Capital requirements for insurers

- 7.2.44 G**
- (1) *PRU 2.1.10R* requires a *firm* to maintain *capital resources* equal to or in excess of its *capital resources requirement (CRR)*. *PRU 2.1* sets out the overall framework of the *CRR*; in particular, *PRU 2.1.15R* requires that for a *firm* carrying on *general insurance business* the *CRR* is equal to the *Minimum Capital Requirement (MCR)*. *PRU 2.1.16R* requires that for a *realistic basis life firms* the *CRR* is the higher of the *MCR* and the *ECR*. *PRU 2.1.21R* requires that for *regulatory basis only life firms* the *CRR* is equal to the *MCR*.
 - (2) For non-life *firms* the *MCR* represents the *minimum capital requirement* (or margin of solvency) prescribed by the *Insurance Directives*. *PRU 2.1.22R* provides that, for a *firm* carrying on *general insurance business*, the *MCR* in respect of that business is the higher of the *base capital resources requirement* for *general insurance business* applicable to that *firm* and the *general insurance capital requirement*. *PRU 2.1.23R* provides that, for a *firm* carrying on *long-term insurance business*, the *MCR* in respect of that business is the higher of the *base capital resources requirement* for *long-term insurance business* applicable to that *firm* and the sum of the *long-term insurance capital requirement* and the *resilience capital requirement*. As specified in *PRU 2.1.11R*, a *firm* carrying on both *general insurance business* and *long-term insurance business* must apply *PRU 2.1.10R* (referred to in paragraph (1) above) separately to its *general insurance business* and its *long-term insurance business*.

PRU 7.2 Capital resources requirements and technical provisions for insurance business

- (3) The calculation of the *general insurance capital requirement* is set out in *PRU 7.2.45G to 7.2.73R* below. *PRU 7.2.74G to 7.2.80R* set out the calculation of the *insurance-related capital requirement* for non-life firms. The calculation of the *long-term insurance capital requirement* is set out in *PRU 7.2.81G to 7.2.92R* below.

General insurance capital requirement

- 7.2.45 G In relation to the *MCR* (see *PRU 7.2.44G*), *PRU 2.1.31R* requires a firm to calculate its *general insurance capital requirement (GICR)* as the highest of the *premiums amount*, the *claims amount*, and the *brought forward amount*. The elements for this computation are set out in *PRU 7.2* as follows:
- (1) the *premiums amount* in *PRU 7.2.46R*;
 - (2) the *claims amount* in *PRU 7.2.48R*; and
 - (3) the *brought forward amount* in *PRU 7.2.52R*.

The premiums amount

- 7.2.46 R The *premiums amount* is:
- (1) **18% of the *gross adjusted premiums amount*; less 2% of the amount, if any, by which the *gross adjusted premiums amount* exceeds €50 million; multiplied by**
 - (2) **the *reinsurance ratio* set out in *PRU 7.2.55R*.**
- 7.2.47 G Rules and guidance as to how the *gross adjusted premiums amount* is to be calculated are set out in *PRU 7.2.57R to PRU 7.2.60G*.

The claims amount

- 7.2.48 R The *claims amount* is:
- (1) **26% of the *gross adjusted claims amount*; less 3% of the amount, if any, by which the *gross adjusted claims amount* exceeds € 35 million; multiplied by**
 - (2) **the *reinsurance ratio* set out in *PRU 7.2.55R*.**
- 7.2.49 G Rules and guidance as to how the *gross adjusted claims amount* is to be calculated are set out in *PRU 7.2.61R to PRU 7.2.66G*.
- 7.2.50 R (1) **Subject to (2) and (3), the Euro amounts specified in *PRU 7.2.46R(1)* and *7.2.48R(1)* will increase each year, starting on the first review date of 20 September 2005 (and annually after that), by the percentage change in the European index of consumer prices (comprising all European Union member states, as published by Eurostat) from 20 March 2002 to the relevant review date, rounded up to a multiple of €100,000.**

- (2) In any year, if the percentage change since the last increase is less than 5%, then there will be no increase.
- (3) The increase will take effect 30 days after the EU Commission has informed the European Parliament and Council of its review and the relevant percentage change.

7.2.51 R For the purposes of *PRU 7.2.46R(1)* and *7.2.48R(1)*, the exchange rate from the Euro to the pound sterling for each year beginning on 31 December is the rate applicable on the last day of the preceding October for which the exchange rates for the currencies of all the European Union member states were published in the Official Journal of the European Communities.

The brought forward amount

7.2.52 R The *brought forward amount* is the *general insurance capital requirement (GICR)* for the prior *financial year*, multiplied, if the ratio is less than one, by the ratio (expressed as a percentage) of:

- (1) the *technical provisions* (calculated net of reinsurance) for *claims* outstanding at the end of the prior *financial year*, determined in accordance with *PRU 7.2.13R*, to
- (2) the *technical provisions* (calculated net of reinsurance) for *claims* outstanding at the beginning of the prior *financial year*, determined in accordance with *PRU 7.2.13R*.

7.2.53 G The *brought forward amount* is the same as the *GICR* for the prior *financial year*, except where *claims* outstanding have fallen during that *financial year*. If they have fallen, the *brought forward amount* is itself reduced by the same percentage fall.

7.2.54 G If the *GICR* for the prior *financial year* is less than the *premiums amount* or the *claims amount*, then a *brought forward amount* is not required to be calculated.

Reinsurance ratio used in calculating the premiums amount and the claims amount

7.2.55 R The reinsurance ratio referred to in *PRU 7.2.46R(2)* and *7.2.48R(2)* is:

- (1) if the ratio lies between 50% and 100%, the ratio (expressed as a percentage) of :
 - (a) the *claims* incurred (net of reinsurance) in the *financial year in question* and the two previous *financial years*, to
 - (b) the gross *claims* incurred in that three-year period;
- (2) 50%, if the ratio calculated in (a) and (b) of (1) is 50% or less; and
- (3) 100%, if the ratio calculated in (a) and (b) of (1) is 100% or more.

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- 7.2.56 G *Rules and guidance* as to how the net and gross *claims* are to be calculated are set out in PRU 7.2.67R to PRU 7.2.72R.

Gross adjusted premiums amount used in calculating the premiums amount

- 7.2.57 R For the purpose of PRU 7.2.46R the *gross adjusted premiums amount* is the higher of the written and earned gross *premiums* (as determined in accordance with PRU 7.2.67R) for the *financial year in question*, adjusted by:
- (1) except for a *pure reinsurer* that does not have *permission* under the *Act* to effect contracts of insurance, increasing by 50% the amount included in respect of the *premiums* for general insurance business classes 11, 12 and 13;
 - (2) deducting 66.7% of the *premiums* for actuarial health insurance that meets the conditions set out in PRU 7.2.73R; and
 - (3) multiplying the resulting figure by 12 and dividing by the number of months in the *financial year*. For the purposes of this calculation, the number of months in the *financial year* is the number of complete calendar months in the *financial year* plus any fractions of a month at the beginning and the end of the *financial year*.
- 7.2.58 G A *firm* may use statistical methods in order to allocate *premiums* in respect of the classes 11, 12 and 13 for the purposes of PRU 7.2.57R.
- 7.2.59 G General insurance business classes 11, 12 and 13 are, respectively, the marine liability, aviation liability and general liability insurance classes.
- 7.2.60 G Where the *firm* did not carry on insurance business in the *financial year in question*, the gross adjusted premiums amount, and therefore the *premiums amount*, is nil.

Gross adjusted claims amount used in calculating the claims amount

- 7.2.61 R For the purpose of PRU 7.2.48R and subject to PRU 7.2.63R, the *gross adjusted claims amount* is the amount of gross claims incurred (as determined in accordance with PRU 7.2.67R) over the reference period (as specified in PRU 7.2.64R) and adjusted by:
- (1) except for a *pure reinsurer* that does not have *permission* under the *Act* to effect contracts of insurance, increasing by 50% the amount included in respect of the claims incurred for general insurance business classes 11, 12 and 13;
 - (2) deducting 66.7% of the *claims* for actuarial health insurance that meets the conditions set out in PRU 7.2.73R; and

- (3) multiplying the resulting figure by 12 and dividing by the number of months in the reference period. For the purposes of this calculation, the number of months in the reference period is the number of complete calendar months in the reference period plus any fractions of a month at the beginning and the end of the reference period.

- 7.2.62 G A *firm* may use statistical methods in order to allocate *claims* in respect of *classes* 11, 12 and 13 for the purposes of *PRU 7.2.61R*.
- 7.2.63 R For the purposes of *PRU 7.2.48R*, in relation to *general insurance business class 18*, the amount of *claims* incurred used to calculate the *gross adjusted claims amount* must be the amount of costs recorded in the *firm's* books in the reference period as borne by the *firm* (whether or not borne in the reference period) in respect of the assistance given.
- 7.2.64 R (1) Except in those cases where paragraph (2) applies, the reference period to be used in *PRU 7.2.61R* and *PRU 7.2.63R* must be:
- (a) the *financial year* in question and the two previous *financial years*; or
 - (b) the period the *firm* had been in existence at the end of the *financial year* in question, if shorter.
- (2) In the case of a *firm* which underwrites only one or more of the *general insurance business risks* of credit, storm, hail or frost (including other business written in connection with such risks), the reference period to be used must be:
- (a) the *financial year* in question and the six previous *financial years*; or
 - (b) the period the *firm* had been in existence at the end of the *financial year* in question, if shorter.
- 7.2.65 G The classification of the risks referred to in *PRU 7.2.64R(2)* is as follows: credit - as included in *general insurance business class 14*; storm – as included in *general insurance business class 8*; hail – as included in *general insurance business class 9*; and frost – as included in *general insurance business class 9*.
- 7.2.66 G Where the *firm* did not carry on *insurance business* in the reference period, the *gross adjusted claims amount*, and therefore the *claims amount*, is nil.

Accounting for premiums and claims

- 7.2.67 R For the purposes of *PRU 7.2.55R*, *PRU 7.2.57R*, *PRU 7.2.61R* and *PRU 7.2.63R*, amounts of *premiums* and *claims* must be:
- (1) determined in accordance with *PRU 1.3 (Valuation)*; and

(2) **adjusted for transfers that were approved by the relevant authority (or became effective where approval by an authority was not required) before the end of the *financial year in question*:**

- (a) **to exclude any amount included in, or adjustment made to, *premiums* and *claims* to reflect the consideration for a transfer of *contracts of insurance* to or from the *firm*;**
- (b) **to exclude *premiums* and *claims* which arose from *contracts of insurance* that have been transferred by the *firm* to another body; and**
- (c) **to account for *premiums* and *claims* which arose from *contracts of insurance* that have been transferred to the *firm* from another body as if they were receivable by or payable to the *firm*.**

- 7.2.68 G To ensure that all rights and obligations under a *contract of insurance* are transferred, a number of alternative mechanisms could be used. These are: an *insurance business* transfer under Part VII of the *Act*; under earlier *United Kingdom* insurance legislation; under equivalent foreign legislation; or by novation of contracts. The term “relevant authority” in paragraph (2) of *PRU 7.2.67R* may refer to whatever body has responsibility in a country, whether within or outside the *EEA*, for the approval of transfers of portfolios of *insurance contracts*; the body may be a supervisory authority for financial services as such or it may be a judicial authority which has the necessary responsibility.
- 7.2.69 G *PRU 7.2.67R(2)(b)* requires a *firm*, for the purpose of calculating its *GICR*, to account for *contracts of insurance* transferred by it to another body as if it had never written those contracts. All amounts of *premiums* and *claims* arising in respect of those contracts are excluded, including amounts that arose in the *financial year in question* or previous *financial years*.
- 7.2.70 G Conversely, *PRU 7.2.67R(2)(c)* requires a *firm*, for the purpose of calculating its *GICR*, to account for *contracts of insurance* transferred to it by another body as if it had been responsible for those contracts from inception and not merely from the date of transfer. All amounts of *premiums* and *claims* that arose from those contracts are included even where they arose prior to the date of transfer and were, in fact, receivable by or payable to the other body.
- 7.2.71 G For both transfers to and from the *firm* the consideration receivable or payable in respect of the transfer is excluded from *premiums* and *claims* in order to avoid double counting.
- 7.2.72 R **Where there has been a significant change in the business portfolio of the *firm* since the end of the *financial year in question*, for example, a line of business has been transferred to another *firm*, or the *firm* no longer carries on a particular *class of insurance business*, then the *gross adjusted premiums amount* and the *gross adjusted claims amount* must both be recalculated to take into account the impact of this change. The recalculation must take into account the requirements of *PRU 1.3 (Valuation)*.**

Actuarial health insurance

7.2.73 R The conditions referred to in *PRU 7.2.57R(2)* and *PRU 7.2.61R(2)* are that:

- (1) the health insurance is underwritten on a similar technical basis to that of life insurance;
- (2) the *premiums* paid are calculated on the basis of sickness tables according to the mathematical method applied in insurance;
- (3) a provision is set up for increasing age;
- (4) an additional *premium* is collected in order to set up a safety margin of an appropriate amount;
- (5) it is not possible for the *firm* to cancel the contract after the end of the third year of insurance; and
- (6) the contract provides for the possibility of increasing *premiums* or reducing payments even for current contracts.

Insurance-related capital requirement (general insurance business only)

7.2.74 G *PRU 2.3.10R* requires *firms* carrying on *general insurance business*, other than a *non-directive insurer*, to calculate their *ECR* as the sum of the *asset-related capital requirement* and the *insurance-related capital requirement* less the *firm's equalisation provisions*. The *ECR* for *firms* carrying on *general insurance business* is an indicative measure of the *capital resources* that a *firm* may need to hold based on risk sensitive calculations applied to its business profile. For *firms* carrying on *general insurance business*, the *FSA* will use the *ECR* as a benchmark for individual capital guidance for a *firm* carrying on *general insurance business*. Details of the calculation of the *asset-related capital requirement* are set out in *PRU 3.3*. Details of the calculation of the *insurance-related capital requirement* are set out in *PRU 7.2.77R* to *7.2.80R*.

7.2.75 G The *insurance-related capital requirement* is a measure of the capital that a *firm* should hold against the risk of:

- (1) an adverse movement in the value of a *firm's* liabilities to recognise that there may be substantial volatility in *claims* and other *technical provisions* made by the *firm*. Such variations may be due to inflationary increases, interest rate changes, movements in the underlying provisions themselves, changes in expense costs, inadequate rate pricing and/or premium collections from intermediaries differing from projected assumptions; and
- (2) the *premiums* a *firm* charges in respect of particular business not being adequate to fund future liabilities arising from that business.

7.2.76 G The *insurance-related capital requirement* is calculated by applying capital charge factors, expressed as a percentage, to the value of the *net written premiums* and the *technical provisions* in respect of different classes of business. *Firms* should refer to *PRU 1.3.6R* which sets out how a *firm* must recognise and value assets and liabilities.

Calculation of the insurance-related capital requirement

- 7.2.77 R** A firm must calculate its *insurance-related capital requirement* in accordance with *PRU 7.2.78R*.
- 7.2.78 R** (1) The value of:
- (a) the *net written premiums*; and
 - (b) the *technical provisions*,
- in respect of each class of business listed in the table in *PRU 7.2.80R* must be multiplied by the corresponding capital charge factor.
- (2) If any amount which is to be multiplied by a capital charge factor is a negative amount, that amount shall be treated as zero.
- (3) The amounts resulting from multiplying the *net written premiums* in respect of each such class of business by the corresponding capital charge factor must be aggregated.
- (4) The amounts resulting from multiplying the *technical provisions* in respect of each such class of business by the corresponding capital charge factor must be aggregated.
- (5) The *insurance-related capital requirement* is the sum of the amounts calculated in accordance with (3) and (4).
- 7.2.79 R** In *PRU 7.2.78R* references to *technical provisions* comprise:
- (1) outstanding claims;
 - (2) provisions for incurred but not reported (*IBNR*) claims;
 - (3) provisions for incurred but not enough reported (*IBNER*) claims;
 - (4) *unearned premium reserves less deferred acquisition costs*; and
 - (5) unexpired risk reserves;
- in each case net of reinsurance receivables.

7.2.80 R Table: Insurance-related Capital Charge Factors

Class of Business	Net Written Premium capital charge factor	Technical provision capital charge factor
Reporting Group: Direct Personal Motor		
Private motor – comprehensive	10.0%	9.0%
Private motor – non-comprehensive	10.0%	9.0%
Motor cycle	10.0%	9.0%

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Reporting Group: Direct Commercial Motor		
Fleets	10.0%	9.0%
Commercial vehicles (non-fleet)	10.0%	9.0%
Reporting Group: Direct Accident & Health		
Private medical insurance	5.0%	7.5%
HealthCare cash plans	5.0%	7.5%
Personal accident or sickness	5.0%	7.5%
Travel	5.0%	7.5%
Reporting Group: Direct Personal Lines Property		
Household and domestic all risks	10.0%	10.0%
Reporting Group: Direct Personal Lines Pecuniary Loss		
Assistance	25.0%	14.0%
Creditor	25.0%	14.0%
Extended warranty	25.0%	14.0%
Legal expenses	25.0%	14.0%
Reporting Group: Direct Commercial Lines Property		
Commercial property damage and theft	10.0%	10.0%
Engineering all risks	10.0%	10.0%
Contractors all risks	10.0%	10.0%
Energy	10.0%	10.0%
Mixed commercial package	10.0%	10.0%
Reporting Group: Direct Commercial Lines Liability		
Employers liability	14.0%	14.0%
Product liability	14.0%	14.0%
Public liability	14.0%	14.0%
Professional indemnity	14.0%	14.0%
Reporting Group: Direct Commercial Lines Pecuniary Loss		
Fidelity and contract guarantee	25.0%	14.0%
Mortgage indemnity	25.0%	14.0%
Credit	25.0%	14.0%
Consequential loss	25.0%	14.0%
Suretyship	25.0%	14.0%
Reporting Group: Direct Aviation		
Aviation liability	32.0%	14.0%
Aviation hull	32.0%	14.0%
Space and satellite	32.0%	14.0%
Reporting Group: Direct Marine		
Marine liability	22.0%	17.0%
Marine hull	22.0%	17.0%
Yacht	22.0%	17.0%
War risks	22.0%	17.0%
Protection and Indemnity	22.0%	17.0%
Freight demurrage and defence	22.0%	17.0%
Reporting Group: Direct Transport		
Goods in transit	12.0%	14.0%
Reporting Group: Direct Miscellaneous		
Miscellaneous direct business	25.0%	14.0%
Reporting Group: Non-Proportional Treaty		
Non-proportional accident & health	35.0%	16.0%
Non-proportional motor	10.0%	14.0%
Non-proportional transport	16.0%	15.0%
Non-proportional aviation	61.0%	16.0%
Non-proportional marine	38.0%	17.0%
Non-proportional property non-catastrophe	53.0%	12.0%
Non-proportional property catastrophe	53.0%	12.0%
Non-proportional liability (non-motor)	14.0%	14.0%

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Non-proportional pecuniary loss	39.0%	14.0%
Non-proportional aggregate cover	53.0%	12.0%
Reporting Group: Proportional Treaty		
Proportional assumed accident & health	12.0%	16.0%
Proportional assumed motor	10.0%	12.0%
Proportional transport	12.0%	15.0%
Proportional aviation	33.0%	16.0%
Proportional marine	22.0%	17.0%
Proportional property	23.0%	12.0%
Proportional liability (non-motor)	14.0%	14.0%
Proportional pecuniary loss	25.0%	14.0%
Proportional aggregate cover	23.0%	12.0%
Reporting Group: Facultative Reinsurance Categories		
Facultative accident & health	5.0%	7.5%
Facultative motor	10.0%	9.0%
Facultative personal property	10.0%	10.0%
Facultative personal financial loss	25.0%	14.0%
Facultative commercial property	10.0%	10.0%
Facultative commercial liability	14.0%	14.0%
Facultative commercial financial loss	25.0%	14.0%
Facultative marine	22.0%	17.0%
Facultative aviation	32.0%	14.0%
Facultative transport	12.0%	14.0%
Reporting Group: Miscellaneous Reinsurance		
Miscellaneous reinsurance accepted business	39.0%	14.0%

Long-term insurance capital requirement

- 7.2.81 G *PRU 2.1.10R requires a firm to which PRU 2 applies to maintain capital resources equal to or in excess of its capital resources requirement. PRU 2.1.16R defines the capital resources requirement for a firm to which that rule applies (a realistic basis life firm) as the higher of the minimum capital requirement (MCR) and the enhanced capital requirement (ECR). For other firms carrying on long-term insurance business (regulatory basis only life firms) the capital resources requirement is equal to the MCR. The MCR is defined as the higher of the base capital resources requirement and the sum of the long-term insurance capital requirement (LTICR) and the resilience capital requirement (see PRU 2.1.21R). PRU 2.1.33R defines the LTICR as the sum of the insurance death, health, expense, and market risk capital components (see PRU 7.2.82R to 7.2.92R). Rules and guidance about the resilience capital requirement are set out in PRU 4.2.10G to 4.2.27R.*

Insurance death risk capital component

- 7.2.82 R **The insurance death risk capital component is the aggregate of the amounts which represent the fractions specified by PRU 7.2.83R of the capital at risk, defined in PRU 7.2.84R, for those contracts where the capital at risk is not a negative figure, multiplied by the higher of:**
- (1) **50%; and**
 - (2) **the ratio as at the end of the preceding financial year of:**
 - (a) **the aggregate capital at risk net of reinsurance cessions; to**
 - (b) **the aggregate capital at risk gross of reinsurance cessions.**

- 7.2.83 R** For the purpose of *PRU 7.2.82R* the fraction is:
- (1) for *long-term insurance business classes I, II and IX*, except for a *pure reinsurer*:
 - (a) 0.1% for temporary insurance on death where the original term of the contract is 3 years or less;
 - (b) 0.15% for temporary insurance on death where the original term of the contract is 5 years or less but more than 3 years; and
 - (c) 0.3% in any other case;
 - (2) 0.3% for *long-term insurance business classes III, VII and VIII*, except for a *pure reinsurer*; and
 - (3) 0.1% for a *pure reinsurer*.
- 7.2.84 R** For the purpose of *PRU 7.2.82R* the capital at risk is:
- (1) where the benefit under a *contract of insurance* payable as a result of death includes periodic or deferred payments, the present value of the benefits payable; and
 - (2) in any other case, the amount payable as a result of death, less, in either case, the *mathematical reserves* for the contract.
- 7.2.85 G** The *insurance death risk capital component* only relates to the risk of death. There is a separate risk component for insured health risks (*class IV*). Tontines (*class V*) and capital redemption operations (*class VI*) also have separate risk components. There is no specified risk margin for other insured risks.

Insurance health risk capital component

- 7.2.86 R** The *insurance health risk capital component* is the highest of:
- (1) the *premiums amount* (determined in accordance with *PRU 7.2.46R*);
 - (2) the *claims amount* (determined in accordance with *PRU 7.2.48R*); and
 - (3) the *brought forward amount* (determined in accordance with *PRU 7.2.52R*),
- in respect of *contracts of insurance* falling in *long-term insurance business class IV* (see *PRU 7.2.87R*).

- 7.2.87 R For the purposes of *PRU 7.2.86R*, in the case of *contracts of insurance falling in long-term insurance business class IV*, condition (3) as set out in *PRU 7.2.73R (Actuarial health insurance)* is modified to: "either the reserves include a provision for increasing age, or the business is conducted on a group basis."
- 7.2.88 G The *insurance health risk capital component* only arises for *permanent health insurance (long-term insurance business class IV)* and *accident and sickness insurance (general insurance business classes 1 and 2)*.

Insurance expense risk capital component

- 7.2.89 R The *insurance expense risk capital component* is:
- (1) in respect of *long-term insurance business classes III, VII and VIII*, an amount equivalent to 25% of the net *administrative expenses* in the preceding *financial year* relevant to the business of each of those classes, in so far as the *firm* bears no investment risk and the allocation to cover *management expenses* in the insurance contract does not have a fixed upper limit which is effective as a limit for a period exceeding 5 years from the commencement of the contract;
 - (2) in respect of any tontine (*long-term insurance business class V*), 1% of the assets of the tontine;
 - (3) in the case of any other *long-term insurance business*, 1% of the "adjusted mathematical reserves" (as defined in *PRU 7.2.91R* and *7.2.92R*).

Insurance market risk capital component

- 7.2.90 R The *insurance market risk capital component* is 3% of the "adjusted mathematical reserves" (as defined in *PRU 7.2.91R* and *7.2.92R*) for all *contracts of insurance* except those which:
- (1) fall in *long-term insurance business classes III, VII or VIII* and in respect of which the *firm* does not bear any investment risk; or
 - (2) fall in *long-term insurance business class V*.

Adjusted mathematical reserves

- 7.2.91 R For the purpose of *PRU 7.2.89R* and *7.2.90R* the "adjusted mathematical reserves" is the amount of *mathematical reserves* (gross of reinsurance cessions), multiplied by the higher of:
- (1) 85% or, in the case of a *pure reinsurer*, 50%; and
 - (2) the ratio as at the end of the preceding *financial year* of:

- (a) the *mathematical reserves* net of reinsurance cessions; to
- (b) the *mathematical reserves* gross of reinsurance cessions.

7.2.92 R The “adjusted mathematical reserves” do not include:

- (1) for the purposes of *PRU 7.2.89R(3)* and *PRU 7.2.90R*, amounts arising from tontines (*long-term insurance business class V*);
- (2) for the purposes of *PRU 7.2.89R(3)*, amounts arising from *insurance business* in *classes III, VII or VIII*, to the extent that such business meets the conditions in *PRU 7.2.89R(1)*;
- (3) for the purposes of *PRU 7.2.90R*, amounts arising from *insurance business* in *classes III, VII or VIII*, to the extent that such business meets the conditions in *PRU 7.2.90R(1)*.

7.3 Mathematical reserves

Application

- 7.3.1 R** This section applies only to a *long-term insurer*, referred to as a *firm* in this section.
- 7.3.2 R** This section does not apply to a *firm* which is:
- (1) a *non-directive friendly society*;
 - (2) an *incoming EEA firm*; or
 - (3) an *incoming Treaty firm*.

Purpose

- 7.3.3 G** This section follows on from the overall requirement on insurance *firms* to establish adequate *technical provisions* (see *PRU 7.2.13G* to *PRU 7.2.20G*). The *mathematical reserves* form the main component of *technical provisions* for *long-term insurance business*. *PRU 7.3* sets out *rules* and *guidance* as to the methods and assumptions to be used in calculating the *mathematical reserves*. The *rules* and *guidance* set out the minimum basis for *mathematical reserves*. Methods and assumptions that produce reserves that are demonstrably equal to or greater than the minimum basis may also be used, though they must meet the basic requirements for methods and assumptions set out in *PRU 7.3.8R* to *PRU 7.3.28G*.
- 7.3.4 G** This section applies to all *firms* carrying on *long-term insurance business* and implements some of the requirements contained in article 20 of the *Life Assurance Directive*. The implementation is designed to ensure that a *firm's mathematical reserves* in respect of *long-term insurance contracts* meet the minimum requirements set by the *Life Assurance Directive*. A *firm* may use a prospective or a retrospective method to value its *mathematical reserves* (see *PRU 7.3.8R*).
- 7.3.5 G** The required procedures are summarised in the flowchart in *PRU 7.3 Ann 1G*.
- 7.3.6 G** *Firms* to which *PRU 2.1.16R* applies are required to calculate a *with-profits insurance capital component* (see *PRU 2.1.35R*). In order to calculate its *with-profits insurance capital component*, such a *firm* is required to carry out additional calculations of its liabilities on a realistic basis (see *PRU 7.4*), which it is required to report to the *FSA* (see *Forms 18,19*). A *firm* that reports its liabilities on a realistic basis is referred to in this section as a *realistic basis life firm*. Such *firms* are subject to different *rules* relating to the calculation of *mathematical reserves* (see *PRU 7.3.47R* and *PRU 7.3.77R*) compared with those that apply to *firms* that report on a regulatory basis only (*regulatory basis only life firms*).
- 7.3.7 G** A number of the *rules* in this section require a *firm* to take into account its regulatory duty to treat *customers* fairly. In this section, references to such a duty are to a *firm's* duty to pay due regard to the interests of its *customers* and to treat them fairly (see Principle 6 in *PRIN*). This duty is owed to both *policyholders* and potential *policyholders*.

Basic valuation method

- 7.3.8 R (1) Subject to (2), a *firm* must establish its *mathematical reserves* using a prospective actuarial valuation on prudent assumptions of all future cash flows expected to arise under, or in respect of, each of its *long-term insurance contracts*.
- (2) But a *firm* may use a retrospective actuarial valuation where:
- (a) a prospective method cannot be applied to a particular type of contract; or
 - (b) the *firm* can demonstrate that the resulting amount of the *mathematical reserves* would be no lower than would be required by a prudent prospective actuarial valuation.
- 7.3.9 G A prospective valuation sets the *mathematical reserves* at the present value of future net cash flows. A retrospective method typically sets the *mathematical reserves* at the level of *premiums* received (and accumulated with investment return), less *claims* and expenses paid. A prospective valuation is preferred because it takes account of circumstances that might have arisen since the *premium* rate was set and of changes in the perception of future experience. Circumstances in which a retrospective valuation might be appropriate include:
- (1) where the assumptions initially made in determining the *premium* rate were sufficiently prudent at inception and have not been overtaken by subsequent events; and
 - (2) where the liability depends on the emerging experience.
- 7.3.10 R Except in PRU 7.3.72R(1), PRU 7.3 does not apply to *final bonuses*. In addition, for *realistic basis life firms* only, PRU 7.3 does not apply to future *annual bonuses*.

Methods and assumptions

- 7.3.11 R In the actuarial valuation under PRU 7.3.8R, a *firm* must use methods and prudent assumptions which:
- (1) are appropriate to the business of the *firm*;
 - (2) are consistent from year to year without arbitrary changes (see PRU 7.3.12G);
 - (3) are consistent with the method of valuing assets (see PRU 1.3);

- (4) include appropriate margins for adverse deviation of relevant factors (see *PRU 7.3.13G*);
- (5) recognise the distribution of profits (that is, emerging surplus) in an appropriate way over the duration of each *contract of insurance*;
- (6) take into account its regulatory duty to treat its *customers* fairly (see *PRIN 6*); and
- (7) are in accordance with generally accepted actuarial best practice.

- 7.3.12 G *PRU 7.3.11R(2)* prohibits only arbitrary changes in methods and assumptions, that is, changes made without adequate reasons. Any such changes would hinder comparisons over time as to the amount of the *mathematical reserves* and so obscure trends in solvency and the emergence of surplus.
- 7.3.13 G The relevant factors referred to in *PRU 7.3.11R(4)* may include, but are not limited to, factors such as future investment returns, expenses, mortality, morbidity, options, persistency and *reinsurance* (see also *PRU 7.3.14R* to *PRU 7.3.20G*).

Margins for adverse deviation

- 7.3.14 R **The appropriate margins for adverse deviation required by *PRU 7.3.11R(4)* must be sufficiently prudent to ensure that there is no significant foreseeable risk that liabilities to *policyholders* in respect of *long-term insurance contracts* will not be met as they fall due.**
- 7.3.15 G The margins for adverse deviation are a prudential margin in respect of the risks that arise under a *long-term insurance contract*.
- 7.3.16 G *PRU 7.3.14R* sets the normal standard of prudence required for margins. *PRU 7.3.17G* suggests benchmarks against which a *firm* should compare the margins it has set in accordance with *PRU 7.3.11R(4)* and *PRU 7.3.14R*. *PRU 7.3.18G* gives *guidance* where a market risk premium is not readily obtainable.
- 7.3.17 G When setting the margins for adverse deviation required by *PRU 7.3.11R(4)* in relation to a particular contract, a *firm* should consider, where appropriate:
- (1) the margin for adverse deviation included in the *premium* for similar *long-term insurance contracts*, if any, newly issued by the *firm*; and
 - (2) where a sufficiently developed and diversified market for transferring a risk exists, the risk premium that would be required by an unconnected party to assume the risk in respect of the contract.

The margin for adverse deviation of a risk should generally be greater than or equal to the relevant market price for that risk.

- 7.3.18 G Where a risk premium is not readily available, or cannot be determined, an external proxy for the risk should be used, such as adjusted industry mortality tables. Where there is a considerable range of possible outcomes, the *FSA* expects *firms* to use stochastic techniques to evaluate these risks. In time, for example, longevity risk, where this constitutes a significant risk for the *firm*, may fall into this category.
- 7.3.19 G The margins for adverse deviation should be recognised as profit only as the *firm* itself is released from risk over the duration of the contract.
- 7.3.20 G Further detailed *rules* and *guidance* on margins for adverse deviation are included in *PRU* 7.3.33G to *PRU* 7.3.92G. In particular, the cross-references for the different assumptions used in calculating the *mathematical reserves* are as follows:
- (1) expenses (*PRU* 7.3.51R to *PRU* 7.3.59G);
 - (2) mortality and morbidity (*PRU* 7.3.60R to *PRU* 7.3.62G);
 - (3) options (*PRU* 7.3.63R to *PRU* 7.3.73G);
 - (4) persistency (*PRU* 7.3.74G to *PRU* 7.3.78G); and
 - (5) *reinsurance* (*PRU* 7.3.79G to *PRU* 7.3.92G).

The *rules* and *guidance* on margins for adverse deviation in respect of future investment returns, which are also required in the calculation of *mathematical reserves*, are set out in *PRU* 4.2.29R to *PRU* 4.2.51G.

Record keeping

- 7.3.21 R **A *firm* must make, and retain for an appropriate period, a record of:**
- (1) the methods and assumptions used in establishing its *mathematical reserves*, including the margins for adverse deviation, and the reasons for their use; and**
 - (2) the nature of, reasons for, and effect of, any change in approach, including the amount by which the change in approach increases or decreases its *mathematical reserves*.**
- 7.3.22 G *PRU* 1.4.54R requires *firms* to maintain accounting and other records for a minimum of three years, or longer as appropriate. For the purposes of *PRU* 7.3.21R, a period of longer than three years will be appropriate for a *firm's long-term insurance business*. In determining an appropriate period, a *firm* should have regard to:
- (1) the detailed *rules* and *guidance* on record keeping in *PRU* 1.4.52G to *PRU* 1.4.65G;
 - (2) the nature and term of the *firm's long-term insurance business*; and
 - (3) any additional provisions or statutory requirements applicable to the *firm* or its records.

Valuation of individual contracts

- 7.3.23 R (1) Subject to (2) and (3), a *firm* must determine the amount of the *mathematical reserves* separately for each *long-term insurance contract*.
- (2) Approximations or generalisations may be made where they are likely to provide the same, or a higher, result.
- (3) A *firm* must set up additional *mathematical reserves* on an aggregated basis for general risks that are not specific to individual contracts.
- 7.3.24 G PRU 7.3.23R to PRU 7.3.92G set out *rules* and *guidance* for the separate prospective valuation of each contract. These may be applied instead to groups of contracts where the conditions set out in PRU 7.3.23R(2) are satisfied.

Contracts not to be treated as assets

- 7.3.25 R A *firm* must not treat a *long-term insurance contract* as an asset.
- 7.3.26 G A separate prospective valuation for each contract may identify contracts for which the value of future cash inflows exceeds that of outflows, that is, the contracts have an asset value, rather than liability value. However, the *surrender value* of a contract is always greater than or equal to zero and the *Life Assurance Directive* requires that no contract should be valued at less than its guaranteed *surrender value*. As a result, no contract should be treated as an asset.

Avoidance of future valuation strain

- 7.3.27 R (1) A *firm* must establish *mathematical reserves* for a *contract of insurance* which are sufficient to ensure that, at any subsequent date, the *mathematical reserves* then required are covered solely by:
- (a) the assets covering the current *mathematical reserves*; and
- (b) the resources arising from those assets and from the contract itself.
- (2) For the purposes of (1), the *firm* must assume that:
- (a) the assumptions adopted for the current valuation of liabilities remain unaltered and are met; and

(b) discretionary benefits and charges will be set so as to fulfil its regulatory duty to treat its *customers* fairly.

(3) (1) may be applied to a group of similar contracts instead of to the individual contracts within that group.

- 7.3.28 G The valuation of each contract, or group of similar contracts, should allow for the possibility, where it exists, that contracts may be surrendered (wholly or in part), lapsed or made paid-up at any time. The valuation assumptions include margins for adverse deviation (see *PRU 7.3.14R*). *PRU 7.3.27R* requires *mathematical reserves* to be established such that, if future experience is in line with the valuation assumptions, there would be no future valuation strain.

Cash flows to be valued

- 7.3.29 R In a prospective valuation, a *firm* must include the following in the cash flows to be valued:
- (1) future *premiums* (see *PRU 7.3.36G* to *PRU 7.3.48G*);
 - (2) expenses, including *commissions* (see *PRU 7.3.51R* to *PRU 7.3.59G*);
 - (3) benefits payable (see *PRU 7.3.30R*); and
 - (4) amounts to be received or paid in respect of the *long-term insurance contracts* under contracts of *reinsurance* or analogous *non-reinsurance* financing agreements (*PRU 7.3.79G* to *PRU 7.3.92G*).
- 7.3.30 R For the purpose of *PRU 7.3.29R*(3), benefits payable include:
- (1) all guaranteed benefits including guaranteed *surrender values* and paid-up values;
 - (2) vested, declared and allotted bonuses to which the *policyholder* is entitled;
 - (3) all options available to the *policyholder* under the terms of the contract; and
 - (4) discretionary benefits payable in accordance with the *firm's* regulatory duty to treat its *customers* fairly.

PRU 7.3 Mathematical reserves

- 7.3.31 G All cash flows are to be valued using prudent assumptions in accordance with generally accepted actuarial best practice. Cash flows may be omitted from the valuation calculations provided the reserves obtained as a result of leaving those cash flows out of the calculation are not less than would have resulted had all cash flows been included (see *PRU 7.3.23R(2)*). Provision for future expenses in respect of *with-profits insurance contracts* (excluding *accumulating with-profits policies*) may be made implicitly, using the *net premium* method of valuation (see *PRU 7.3.44R* below). For the purposes of *PRU 7.3.29R(2)*, any charges included in expenses should be determined in accordance with the *firm's* regulatory duty to treat its *customers* fairly.
- 7.3.32 G *PRU 7.3.30R(4)* requires *regulatory basis only life firms* to make allowance for any future *annual bonus* that a *firm* would expect to grant, assuming future experience is in line with the assumptions used in the calculation of the *mathematical reserves*. *Final bonuses* do not have to be taken into consideration in these calculations (see *PRU 7.3.10R*). For *realistic basis life firms*, except for *accumulating with-profits policies*, the *mathematical reserves* may be calculated as the amount required to cover guaranteed benefits as for such *firms* full allowance for discretionary benefits is made in the calculation of the *realistic value of liabilities* (see *PRU 7.4.102R(5)*). The calculations required for *accumulating with-profits policies* are set out in *PRU 7.3.72R(1)*.

Valuation assumptions: detailed rules and guidance

- 7.3.33 G More detailed *rules* and *guidance* about the valuation of cash flows are set out in *PRU 7.3.34R* to *PRU 7.3.92G*.

VALUATION RATES OF INTEREST

- 7.3.34 R **In calculating the present value of future net cash flows, a *firm* must determine the rates of interest to be used in accordance with *PRU 4.2.29R* to *PRU 4.2.50R*.**
- 7.3.35 G The *rules* in *PRU 4.2.29R* to *PRU 4.2.50R* set out the approach *firms* must take in setting margins for adverse deviation in the interest rates assumed in calculating the *mathematical reserves*. This includes a margin to allow for adverse deviation in *market risk* and, where relevant, credit risk and liquidity risk. The requirements set out in *PRU 4.2.29R* to *PRU 4.2.50R* protect against the *market risk* that the return actually achieved on assets may fall below the market yields on assets at the *actuarial valuation date*.

FUTURE PREMIUMS

- 7.3.36 G *PRU 7.3.47R* and *PRU 7.3.48G* apply to the valuation of *with-profits insurance liabilities* for a *realistic basis life firm*. *PRU 7.3.39R* to *PRU 7.3.46G* apply to a *regulatory basis only life firm*.
- 7.3.37 G For *non-profit insurance contracts* no specific method of valuation for future *premiums* is required by *PRU*. However, the method of valuation used should be sufficiently prudent taking into account, in particular, the risk of voluntary discontinuance by the *policyholder*.

FUTURE PREMIUMS- FIRMS REPORTING ONLY ON A REGULATORY BASIS

- 7.3.38 R ***PRU 7.3.39R to PRU 7.3.44R apply to a firm that is a regulatory basis only life firm.***
- 7.3.39 R (1) ***This rule applies to with-profits insurance contracts except accumulating with-profits policies written on a recurring single premium basis.***
- (2) ***The value attributed to a premium due in any future financial year (a future premium) must not exceed the lower of the value of:***
- (a) ***the actual premium payable under the contract; and***
- (b) ***the net premium.***
- (3) ***The net premium may be increased for deferred acquisition costs in accordance with PRU 7.3.44R.***
- 7.3.40 G The valuation method for future *premiums* in *PRU 7.3.39R* retains the difference, if any, between the gross *premium* and the *net premium* as an implicit margin available to finance future bonuses, expenses and other costs. It thus helps to protect against the risk that adequate resources may not be available in the future to meet those costs.
- 7.3.41 R ***Where the terms of a contract of insurance have changed since it was first entered into, a firm must apply one of the methods in PRU 7.3.42R in determining the net premium for the purpose of PRU 7.3.39R(2)(b).***
- 7.3.42 R ***A firm must treat the change referred to in PRU 7.3.41R as if either:***
- (1) ***it had been included in the original contract but came into effect from the time the change became effective; or***
- (2) ***the original contract were cancelled and replaced by a new contract (with an initial premium paid on the new contract equal to the liability under the original contract immediately prior to the change); or***
- (3) ***it gave rise to two separate contracts where:***
- (a) ***all premiums are payable under the first contract and that contract provides only for such benefits as those premiums could have purchased from the firm at the date the change became effective; and***
- (b) ***no premiums are payable under the second contract and that contract provides for all the other benefits.***

- 7.3.43 G *PRU 7.3.42R* permits three alternative methods. However, the third method is only possible where a meaningful comparison can be made between the terms of the contract (as changed) and the terms upon which the *firm* was effecting its new *contracts of insurance* at the time the contract was changed.

FUTURE NET PREMIUMS: ADJUSTMENT FOR DEFERRED ACQUISITION COSTS

- 7.3.44 R (1) The amount of any increase to the *net premium* for *deferred acquisition costs* must not exceed the equivalent of the recoverable acquisition expenses spread over the period of *premium* payments and calculated in accordance with the rates of interest, mortality and morbidity assumed in calculating the *mathematical reserves*.
- (2) For the purpose of (1), recoverable acquisition expenses means the amount of expenses, after allowing for the effects of taxation, which it is reasonable to expect will be recovered from future *premiums* payable under the contract.
- (3) The recoverable acquisition expenses in (1) must not exceed the lower of:
- (a) the value of the excess of actual *premiums* over *net premiums*; and
 - (b) 3.5% of the *relevant capital sum*.
- (4) Recoverable acquisition expenses may be calculated as the average for a group of similar contracts weighted by the *relevant capital sum* for each contract.
- 7.3.45 G *PRU 7.3.44R* allows a *firm* to spread acquisition costs over the lifetime of a *contract of insurance*, but only if it is reasonable to expect those costs to be recoverable from future *premium* income from that contract. Further prudence is provided by the limitation of recoverable acquisition expenses to 3.5% of the *relevant capital sum*. This adjustment for acquisition costs is sometimes termed a Zillmer adjustment.
- 7.3.46 G In determining the extent, if any, to which it is reasonable to expect acquisition costs to be recoverable from future *premium* income, the *firm* should make prudent assumptions as to levels of voluntary discontinuance by *policyholders*.

FUTURE PREMIUMS- FIRMS ALSO REPORTING WITH-PROFITS INSURANCE LIABILITIES ON A REALISTIC BASIS

- 7.3.47 R (1) Subject to (2), for a *realistic basis life firm*, the future *premiums* to be valued in the calculation of the *mathematical reserves* for its *with-profits insurance contracts* must not be greater than the gross *premiums* payable by the *policyholder*.

- (2) This rule does not apply to *accumulating with-profits policies* written on a recurring single *premium* basis (see PRU 7.3.49R).**

7.3.48 G The gross *premium* is the full amount of *premium* payable by the *policyholder* to the *firm*. The gross *premium* method contrasts with the *net premium* method which is required from *regulatory basis only life firms* (see PRU 7.3.38R to PRU 7.3.46G).

FUTURE PREMIUMS- ACCUMULATING WITH-PROFITS POLICIES

- 7.3.49 R **(1) This rule applies to *accumulating with-profits policies* written on a recurring single *premium* basis.**
- (2) A *firm* must not attribute any value to a future *premium* under the contract.**
- (3) Any liability arising only upon the payment of that *premium* may be ignored except to the extent that the value of that liability upon payment would exceed the amount of that *premium*.**
- 7.3.50 G PRU 7.3.49R prohibits a *firm* from taking credit for recurring single *premiums* under *accumulating with-profits policies*. As there is no contractual commitment to pay any future *premiums* the amount and timing of which are uncertain, the recognition of any potential margins would not be prudent. Where the payment of a future *premium* would give rise to a liability in excess of the *premium* a provision should be established.

EXPENSES

- 7.3.51 R **(1) A *firm* must make provision for expenses, either implicitly or explicitly, in its *mathematical reserves* of an amount which is not less than the amount expected, on prudent assumptions, to be incurred in fulfilling its *long-term insurance contracts*.**
- (2) For the purpose of (1), expenses must be valued:**
- (a) after taking account of the effect of taxation;**
 - (b) having regard to the *firm's* actual expenses in the last 12 *months* before the *actuarial valuation date* and any increases in expenses expected to occur in the future;**
 - (c) after making prudent assumptions as to the effects of inflation on future increases in prices and earnings; and**
 - (d) at no less than the level that would be incurred if the *firm* were to cease to transact new business 12 *months* after the *actuarial valuation date*.**

(3) **A firm must not rely upon an implicit provision arising from the method of valuing future *premiums* except to the extent that:**

- (a) **it is reasonable to assume that expenses will be recoverable from future *premiums*; and**
- (b) **the expenses would only arise if the future *premiums* were received.**

- 7.3.52 G For *with-profits insurance contracts* where the *net premium* valuation method applies, an implicit provision arises because the future *premiums* valued are limited to the *net premium* adjusted as permitted by PRU 7.3.44R. This excludes the allowance within the gross *premium* for expenses (other than recoverable acquisition expenses). It also excludes other margins within the actual *premium* that are a prudential margin in respect of the risks that arise under the contract or that are needed to provide for future discretionary benefits. To the extent that these other margins are not needed for the purpose for which they were originally established, they may also constitute an implicit provision for expenses.
- 7.3.53 G An implicit provision may also arise for other types of *long-term insurance contract* where, for example, no value is attributed to future *premiums*, but the *firm* is entitled to make deductions from future regular *premiums* before allocating them to secure *policyholder* benefits.
- 7.3.54 G A *firm* should only reduce the provision for future expenses to take account of expected taxation recoveries related to those expenses where recovery is reasonably certain, and after taking into account the assumption that the *firm* ceases to transact new business 12 *months* after the *actuarial valuation date*. An appropriate adjustment for discounting should be made where receipt of the taxation recoveries is not expected until significantly after the expenses are incurred.
- 7.3.55 G The *firm's* actual expenses in the 12 *months* prior to the *actuarial valuation date* may serve as a guide to the assumptions for future expenses, taking into consideration the mix of acquisition and renewal expenses. The expense assumptions should not be reduced to account for expected future improvements in efficiency until such efficiency improvements result in a reduced level of actual expenditure. However, the assumptions should take account of all factors which might increase costs including earnings and price inflation.
- 7.3.56 R **The provisions for expenses (whether implicit or explicit) required by PRU 7.3.51R must be sufficient to cover all the expenses of running off the *firm's* existing *long-term insurance business* including:**
- (1) **all discontinuance costs (for example, redundancy costs and closure costs) that would arise if the *firm* were to cease transacting new business 12 *months* after the *actuarial valuation date* in circumstances where (and to the extent that) the discontinuance costs exceed the projected surplus available to meet such costs;**
 - (2) **all costs of continuing to service the existing business taking into account the loss of economies of scale from, and any other likely consequences of, ceasing to transact new business at that time; and**

(3) the lower of:

- (a) any projected valuation strain from writing new business for the 12 months following the *actuarial valuation date* to the extent the actual amount of that strain exceeds the projected surplus on prudent assumptions from existing business in the 12 months following the *actuarial valuation date*; and**
- (b) any projected new business expense overrun from writing new business for the 12 months following the *actuarial valuation date* to the extent the projected expenses exceed the expenses that the new business can support on a prudent basis.**

- 7.3.57 G The provision for future expenses, whether implicit or explicit, should include a prudent margin for adverse deviation in the level and timing of expenses (see *PRU 7.3.14R* to *PRU 7.3.20G*). The margin should cover the risk of underestimating expenses whether due to, for example, initial under-calculation or subsequent increases in the amount of expenses. In setting the amount of the margin, the *firm* should take into account the extent to which:
- (1) an appropriately validated method based on reliable data is used to allocate expenses by product type, by distribution channel and as between acquisition and non-acquisition expenses;
 - (2) the volume of existing and new business and its distribution by product type or distribution channel is stable or predictable;
 - (3) costs vary in the short, medium or long term dependent upon the volume of existing or new business and its distribution by product type or distribution channel; and
 - (4) cost control is well-managed.
- 7.3.58 G In setting the margin, the *firm* should also take into account:
- (1) the length of the period over which it is necessary to project costs;
 - (2) the extent to which it is reasonable to expect inflation to be stable or predictable over that period; and
 - (3) whether, if inflation is higher than expected, it is reasonable to expect that the excess would be offset by increases in investment returns.
- 7.3.59 G Where a *firm* has entered into an agreement with any other person for the sharing or reimbursement of costs, in setting the margin it should take into account the potential impact of that agreement and of its discontinuance.

MORTALITY AND MORBIDITY

- 7.3.60 R A firm must set the assumptions for mortality and morbidity using prudent rates of mortality and morbidity that are appropriate to the country or territory of residence of the person whose life or health is insured.**
- 7.3.61 G The rates of mortality or morbidity should contain prudent margins for adverse deviation (see *PRU 7.3.14R* to *PRU 7.3.20G*). In setting those rates, a *firm* should take account of:
- (1) the systems and controls applied in underwriting *long-term insurance contracts* and whether they provide adequate protection against anti-selection (that is, selection against the *firm*) including:
 - (a) adequately defining and identifying non-standard risks; and
 - (b) where such risks are underwritten, allocating to them an appropriate weighting;
 - (2) the nature of the contractual exposure to mortality or morbidity risk including:
 - (a) whether lower mortality increases or decreases the *firm's* liability;
 - (b) the period of cover and whether risk charges can be varied during that period and, if so, how quickly; and
 - (c) whether the options in the contract give rise to a significant risk of anti-selection (for example, opportunities for voluntary discontinuance, guaranteed renewal at the option of the *policyholder* and rights for conversion of benefits);
 - (3) the credibility of the *firm's* actual experience as a basis for projecting future experience including:
 - (a) whether there is sufficient data (especially for medical or financial risks and for new types of benefit or new methods of distribution); and
 - (b) whether the data is reliable and has been appropriately validated;
 - (4) the availability and reliability of:
 - (a) any published tables of mortality or morbidity for the country or territory of residence of the person whose life or health is insured; and
 - (b) any other information as to the industry-wide insurance experience for that country or territory;
 - (5) anticipated or possible future trends in experience including, but only where they increase the liability:
 - (a) anticipated improvements in mortality;
 - (b) changes arising from improved detection of morbidity (including critical illnesses);
 - (c) diseases the impact of which may not yet be reflected fully in current experience; and

- (d) changes in market segmentation (such as impaired life annuities) which, in the light of developing experience, may require different assumptions for different parts of the policy class.
- 7.3.62 G An additional provision for diseases covered by *PRU 7.3.61G(5)(c)* may be needed, in particular for unit-linked policies. In determining whether such a provision is needed a *firm* may take into consideration any ability to increase product charges commensurately (provided that such increase does not infringe on its regulatory duty to treat its *customers* fairly), but a provision would still be required for the period until such an increase could be brought into effect.

OPTIONS

- 7.3.63 R **When a *firm* establishes its *mathematical reserves* in respect of a *long-term insurance contract*, the *firm* must include an amount to cover any increase in liabilities which might be the direct result of its *policyholder* exercising an option under, or by virtue of, that *contract of insurance*. Where the *surrender value* of a contract is guaranteed, the amount of the *mathematical reserves* for that contract at any time must be at least as great as the value guaranteed at that time.**
- 7.3.64 G An option exists where a *policyholder* is given a choice between alternative forms of benefit, for example, a choice between receiving a cash benefit upon maturity or an annuity at a guaranteed rate. In some cases, the contract may designate one or other of these alternatives as the principal benefit and any other as an option. This designation, in itself, is not one of substance in the context of reserving since it does not affect the *policyholder's* choices. Other forms of option include:
- (1) the right to convert to a different contract on guaranteed terms;
 - (2) the right to increase cover on guaranteed terms;
 - (3) the right to a specified amount on surrender; and
 - (4) the right to a paid up value.
- 7.3.65 G The *firm* should provide for the benefit which the *firm* anticipates the *policyholder* is most likely to choose. Except for the “option” of voluntary discontinuance in the case of *regulatory basis only life firms* (see *PRU 7.3.75R*), past experience may be used as a guide, but only if this is likely to give a reasonable estimate of future experience. For example, past experience of the take-up of a cash payment option instead of an annuity would not be a reliable guide if, in the past, market rates exceeded those guaranteed in the annuity but no longer do so. Similarly, past experience on the take-up of options may not be relevant in the light of the assumptions made in respect of future interest rates and mortality rates in the valuation of the benefits.
- 7.3.66 G Many options are long- term and need careful consideration. Improving longevity, for example, can increase the value of guaranteed annuity options vesting further in the future. *Firms* also need to have regard to the fact that *policyholder* behaviour can change in the future as *policyholders* become more aware of the value of their options. The impact on *policyholder* behaviour of possible changes in taxation should also be considered.

- 7.3.67 G In accordance with *PRU 7.3.8R* and *PRU 7.3.14R* take-up rates for guaranteed annuity options should be assessed on a prudent basis with assumptions that include margins for adverse deviation (see *PRU 7.3.14R* to *PRU 7.3.20G*) that take account of current experience and the potential for future change. The *firm* should reserve for option take-up at least at a prudent margin over current experience for options shortly to vest. For longer term options where the option becomes increasingly valuable in the future due to projected mortality improvements, increased take-up rates should be assumed. In view of the growing uncertainty over take-up rates for projections further in the future, for guaranteed annuity option dates 20 years or more ahead at least a 95% take-up rate assumption should be made.
- 7.3.68 G Where there is considerable variation in the cost of the option depending on conditions at the time the option is exercised, and where that variation constitutes a material risk for the *firm*, it will generally be appropriate to use stochastic modelling. In this case prices from the asset model used in the stochastic approach should be benchmarked to relevant market asset prices before determining the value of the option. Where stochastic modelling is not undertaken, market option prices should be used to determine suitable assumptions for the valuation of the option. If no market exists for a particular option, a *firm* should take the value of the nearest equivalent benefit or right for which a market exists and document the way in which it has adjusted that valuation to reflect the original option.
- 7.3.69 G Where the option offers a choice between two non-discretionary financial benefits (such as between a guaranteed cash sum or a guaranteed annuity value, or between a unit value and a maturity guarantee) and where there is a wide range of possible outcomes, then the *firm* should normally model such liabilities stochastically. In carrying out such modelling *firms* should take into account the likely choices to be made by *policyholders* in each scenario. *Firms* should make and retain a record of the development and application of the model.
- 7.3.70 G The value of a contract with an option is greater than the value of a similar contract without the option, that is, the option has value whether it is expected to be exercised or not. Although in theory a *firm* can rebalance its investments to match the expected cost of the option to the *firm* (including the time value of the option), this takes time to achieve and the market may move more quickly than the *firm* is able to respond. Also, there are likely to be transaction costs. *Firms* should take these aspects into consideration in setting up *mathematical reserves*.
- 7.3.71 R (1) **Where a *policyholder* may opt to be paid a cash amount, or a series of cash payments, the *mathematical reserves* for the *contract of insurance* established under *PRU 7.3.8R* must be sufficient to ensure that the payment or payments could be made solely from:**
- (a) **the assets covering those *mathematical reserves*; and**
 - (b) **the resources arising from those assets and from the contract itself.**
- (2) **In (1) references to a cash amount or a series of cash payments include the amount or amounts likely to be paid on a voluntary discontinuance.**

- (3) For the purposes of (1), the *firm* must assume that:
 - (a) the assumptions adopted for the current valuation remain unaltered and are met; and
 - (b) discretionary benefits and charges will be set so as to fulfil the *firm's* regulatory duty to treat its *customers* fairly.
- (4) (1) may be applied to a group of similar contracts instead of to the individual contracts within that group.

7.3.72 R For the purposes of *PRU 7.3.71R*, a *firm* must assume that the amount of a cash payment secured by the exercise of an option is:

- (1) in the case of an *accumulating with-profits policy*, the lower of:
 - (a) the amount which the *policyholder* would reasonably expect to be paid if the option were exercised, having regard to the representations made by the *firm* and including any expectations of a *final bonus*; and
 - (b) that amount, disregarding all discretionary adjustments;
- (2) in the case of any other *policy*, the amount which the *policyholder* would reasonably expect to be paid if the option were exercised, having regard to the representations made by the *firm*, without taking into account any expectations regarding future distributions of profits or the granting of discretionary additions in respect of an *established surplus*.

7.3.73 G In *PRU 7.3.72R(1)(a)* *firms* must take into consideration, for example, a market value adjustment where such an adjustment has been described in representations made to *policyholders* by the *firm*. However, any discretionary adjustment, such as a market value adjustment, cannot be included in the amount calculated in *PRU 7.3.72R(1)(b)*.

PERSISTENCY ASSUMPTIONS

7.3.74 G *PRU 7.3.77R* and *PRU 7.3.78G* apply to the valuation of the *with-profits insurance liabilities* of *realistic basis life firms*. *PRU 7.3.75R* and *PRU 7.3.76G* apply to the valuation of all other liabilities.

7.3.75 R Except as permitted by *PRU 7.3.77R*, a *firm* must not make any allowance in the calculation of the *mathematical reserves* for the voluntary discontinuance of any *contract of insurance* if the amount of the *mathematical reserves* so determined would, as a result, be reduced.

- 7.3.76 G The rate of voluntary discontinuance (that is, lapse, surrender or paying up) is often difficult to predict and may be volatile especially in the short term during stressful economic conditions. Depending upon the circumstances and contract terms, voluntary discontinuance may increase or decrease the *firm's* liability. In effect, *PRU 7.3.75R* requires a *firm* to assume that there will be no voluntary discontinuance if assuming voluntary discontinuance would reduce the liability. This protects against the risk that arises from volatility in the rate of voluntary discontinuance. In addition, there is the risk of assets not being realisable when needed due to the rates of discontinuance exceeding expected levels.
- 7.3.77 R **A realistic basis life firm may make assumptions about voluntary discontinuance rates in the calculation of the *mathematical reserves* for its *with-profits insurance business* provided that those assumptions meet the general requirements for prudent assumptions as set out in *PRU 7.3.11R* and *PRU 7.3.14R*.**
- 7.3.78 G The prudential margin in respect of assumptions of voluntary discontinuance should be validated both in relation to recent experience and to variations in future experience that might arise as a result of reasonably foreseeable changes in conditions. In particular, where estimates of experience are being made well into the future, the assumptions should contain margins that take into account the increased risk of adverse experience arising from changed circumstances. *Firms* should also consider the possibility of anti-selection by *policyholders* and of variations in persistency experience for different classes and cohorts of business.

REINSURANCE

- 7.3.79 G The prospective valuation of future cash flows to determine the amount of the *mathematical reserves* includes amounts to be received or paid under contracts of *reinsurance* in respect of *long-term insurance business* (see *PRU 7.3.29R(4)*). This applies even where those cash flows cannot be identified as related to particular *long-term insurance contracts* (see *PRU 7.3.23R(3)*).
- 7.3.80 R **A firm must value *reinsurance* cash flows using methods and assumptions which are at least as prudent as the methods and assumptions used to value the underlying *contracts of insurance* which have been reinsured. In particular:**
- (1) ***reinsurance* recoveries must not be recognised unless the underlying liabilities to which they relate have also been recognised;**
 - (2) ***reinsurance* cash outflows that are unambiguously linked to the emergence as surplus of margins included in the valuation of existing *contracts of insurance* or to the exercise by a reinsurer of its rights under a termination clause need not be separately valued (see *PRU 7.3.86R*); and**

(3) *reinsurance* cash inflows that are contingent on factors or conditions other than the insurance risks that are reinsured must not be valued.

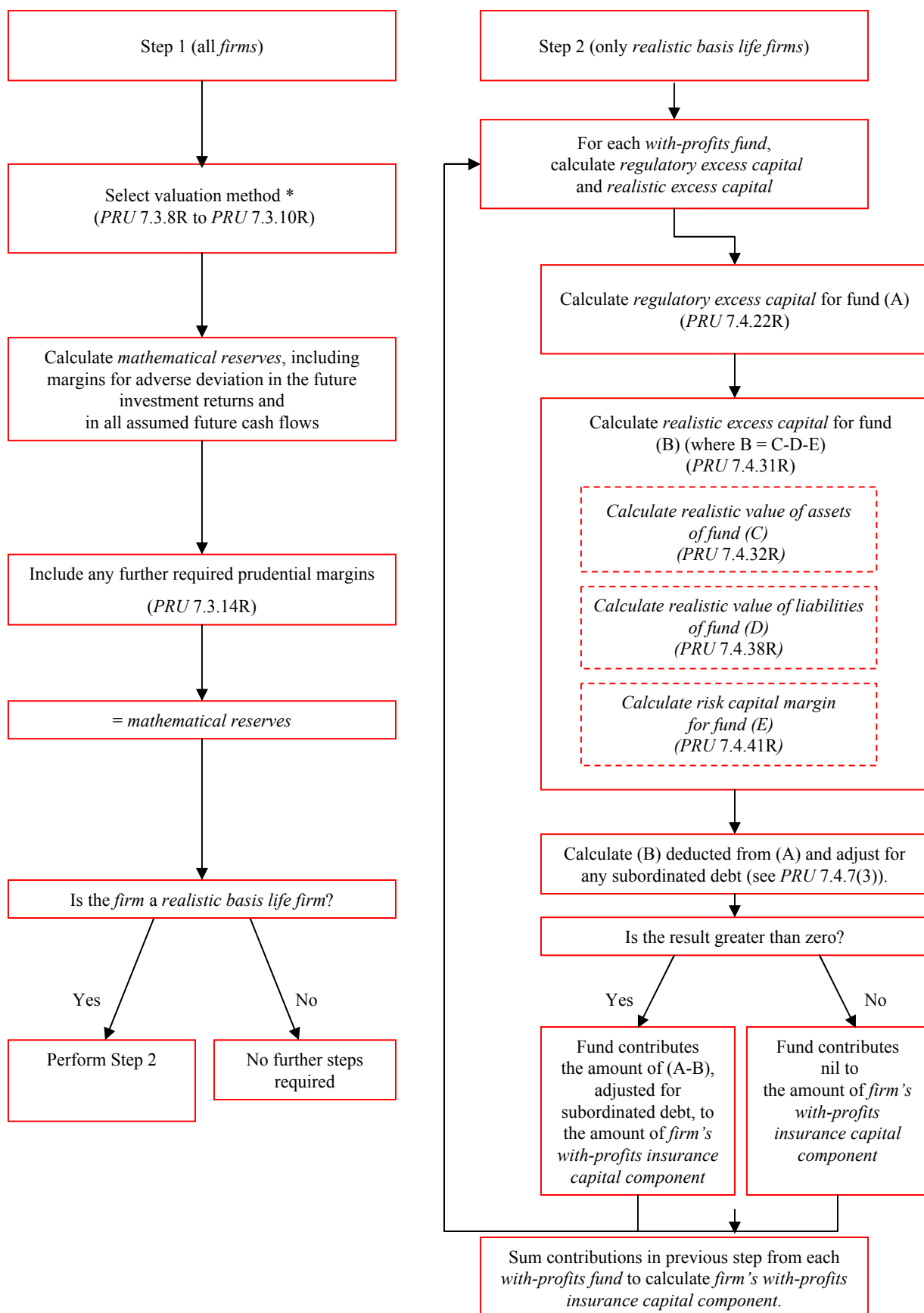
- 7.3.81 G In valuing *reinsurance* cash flows, a *firm* should establish prudent margins for adverse deviation (see *PRU 7.3.14R* to *PRU 7.3.20G*) including margins in respect of:
- (1) any uncertainty as to the amount or timing of amounts to be paid or received; and
 - (2) the risk of credit default by the *reinsurer*.
- 7.3.82 G In assessing the risk of credit default, the *firm* should take into account the *rules* and *guidance* in *PRU 3.2* (Credit risk in insurance).
- 7.3.83 G It will not necessarily be appropriate to use the same assumptions in *PRU 7.3.80R* as for the underlying contracts. For example, if only a subgroup of the original contracts is reinsured, it may be appropriate to use different mortality rates.
- 7.3.84 G Only *reinsurance* cash inflows that are triggered unambiguously by the insurance risks of the *firm* that are reinsured may be valued. *Reinsurance* cash inflows that depend on other contingencies where the outcome does not form part of the valuation basis should not be given credit.
- 7.3.85 G *Firms* should assess the extent of margins in the valuation of the existing *contracts of insurance* where these provide implicit provision for the *reinsurance* cash outflows in *PRU 7.3.80R*. Where the *reinsurance* asset exceeds the estimated value of the future surplus under reinsured contracts *firms* should assess their *credit risk* exposure to the *reinsurer*.
- 7.3.86 R For the purposes of *PRU 7.3.80R(2)*, the “link” must be such that a contingent liability to pay or repay the amount to the *reinsurer* could not arise except when, and to the extent that, the margins in the valuation of the existing *contracts of insurance* emerge as surplus, or the *reinsurer* exercises its rights under a termination clause as a result of fraud, misrepresentation, the non-payment of *reinsurance premiums* by the *firm* or a failure by the *firm* to obtain the agreement of the *reinsurer* to a transfer of business by the *firm*.**
- 7.3.87 R For the purposes of *PRU 7.3.80R(2)* and *PRU 7.3.86R*, future surplus may only be offset against future *reinsurance* cash outflow in respect of surplus on *non-profit insurance contracts* and the charges or shareholder transfers arising as surplus from *with-profits insurance contracts*. Such charges and transfers may only be allowed for to the extent consistent with the regulatory duty of the *firm* to treat its *customers* fairly.**
- 7.3.88 G For the purposes of *PRU 7.3.86R* a contingent liability means a liability that would only arise upon the happening of a particular contingency, even where that contingency is not expected to occur. For example, if the *firm* has a *reinsurance* arrangement in force that in the event the *firm* were wound up would give rise to repayments other than out of surplus emerging, the *reinsurance* cash outflows should be valued as a liability.

PRU 7.3 Mathematical reserves

- 7.3.89 G *PRU 7.3.86R* allows a *firm* not to value *reinsurance* cash outflows provided the contingencies in which the *reinsurance* would require repayment other than out of future surpluses are limited to contract conditions concerning fraud, misrepresentation or non-payment of *reinsurance premiums* by the *firm*. Such conditions would include a clause requiring any transfer of business out of the *firm* to be subject to the agreement of the *reinsurer*.
- 7.3.90 G Where the *reinsurance* cash outflow is payable by a fund or sub-fund that generates such profits, charges or transfers, the *firm* need make no provision for such payments provided that repayment to the *reinsurer* is linked unambiguously (as defined in *PRU 7.3.86R*) to the emergence of future surplus. Where the profits, charges or transfers arising under a block of business are payable by a fund or sub-fund to another part of the *firm* then only where the *firm* has committed to remit such profits, charges or transfers directly to the *reinsurer* would it be acceptable for no provision for payments to the *reinsurer* to be made.
- 7.3.91 R **In *PRU 7.3.79G* to *PRU 7.3.90G* references to *reinsurance* and contracts of *reinsurance* include analogous non-*reinsurance* financing agreements.**
- 7.3.92 G In *PRU 7.3.79G* to *PRU 7.3.90G* references to *reinsurance* cash outflow include any provision for the reduction in *policy* liabilities recognised as covered under a contract of *reinsurance* or for the reduction of any debt to the *firm* previously created under a contract of *reinsurance*. In *PRU 7.3.91R* analogous non-*reinsurance* financing agreements include contingent loans, securitisations and any other arrangements giving rise to charges on future surplus arising.

Annex 1G

PRU 7.3 (Mathematical reserves) and PRU 7.4 (With-profits insurance capital component)



For conventional *with-profits insurance business*, where a firm is a *regulatory basis only firm* (see PRU 7.3.6G), the *net premium* method of valuation has to be used (PRU 7.3.38R to PRU 7.3.46G)

7. 4 With-profits insurance capital component

Application

- 7.4.1 R** This section applies to an *insurer* which is a ***realistic basis life firm***, referred to as a ***firm*** in this section.
- 7.4.2 G** A *realistic basis life firm* means a *firm* to which PRU 2.1.16R applies. The application of PRU 2.1.16R is set out in PRU 2.1.17R and PRU 2.1.18R. PRU 2.1.10R requires that a *firm* must maintain at all times *capital resources* equal to or in excess of its *capital resources requirement*. The *enhanced capital requirement* forms part of the *capital resources requirement* for a *realistic basis life firm*. The *with-profits insurance capital component (WPICC)* forms part of the *enhanced capital requirement* which a *realistic basis life firm* is required to calculate in accordance with PRU 2.1.35R.

Purpose

- 7.4.3 G** This section (PRU 7.4) sets out *rules* and *guidance* as to the methods and assumptions to be used in calculating the *with-profits insurance capital component*.
- 7.4.4 G** The purpose of the *with-profits insurance capital component* is to supplement the *mathematical reserves* so as to ensure that a *firm* holds adequate financial resources for the conduct of its *with-profits insurance business*. In particular, capital in excess of the *mathematical reserves* may be needed to ensure that adequate *final bonuses* can be awarded to *customers*. That is, adequate in the sense that in setting bonuses payable to *customers* the *firm* pays due regard to the interests of its *customers* and treats them fairly. The *mathematical reserves* for a *realistic basis life firm* are not required to include provision for future *annual bonuses* or *final bonuses* (PRU 7.3.10R).
- 7.4.5 G** The required procedures are summarised in the flowchart in PRU 7.3 Ann 1G.

Main requirements

- 7.4.6 R** A *firm* must calculate the *with-profits insurance capital component* in accordance with PRU 7.4.7R.
- 7.4.7 R** (1) The *with-profits insurance capital component* for a *firm* is the aggregate of any amounts that:
- (a) result from the calculations specified in (2) and (3); and
 - (b) are greater than zero.
- (2) Subject to (3), in relation to each *with-profits fund* within the *firm*, the *firm* must deduct B from A, where:
- (a) A is the amount of the *regulatory excess capital* for that fund (see PRU 7.4.22R); and

(b) **B is the amount of the *realistic excess capital* for that fund (see *PRU 7.4.31R*).**

(3) **Where a capital instrument that can be included in the *firm's capital resources* in accordance with *PRU 2.2* has been attributed wholly or partly to the *firm's with-profits funds* and that instrument meets the requirements of *PRU 2.2.89R*, the *firm* must add to the amount calculated under (2) for that fund the result, subject to a minimum of zero, of deducting D from C where:**

(a) **C is the outstanding face amount of the instrument to the extent attributed to the fund; and**

(b) **D is the realistic value of the instrument to the extent attributed to the fund in the single event that determines the *risk capital margin* under *PRU 7.4.41R*.**

7.4.8 G Subordinated debt which is subordinated to *policyholder* interests (see *PRU 2.2.93R*) is an example of the sort of capital instrument that may give rise to a component of the WPICC under *PRU 7.4.7R(3)*. Such instruments are treated as capital under *PRU 2.2*, subject to the requirements of *PRU 2.2.93R*. Under realistic reserving the capital instrument is valued as a realistic liability (see *PRU 7.4.38R*) and in calculating the *risk capital margin* such an instrument would be valued at its realistic value in the single event outlined in *PRU 7.4.41R* (see also *PRU 7.4.160R*). Overall, the effect of *PRU 2.2*, *PRU 7.4.7R(3)* and *PRU 7.4.41R* is to enable a *firm* that obtains subordinated debt to benefit from additional *capital resources* equal to the face amount of that debt.

7.4.9 G *SUP 4* (Actuaries) sets out the role and responsibilities of the *actuarial function* and of the *with-profits actuary*.

(1) *SUP 4* requires the *actuarial function* to calculate the *mathematical reserves* and, in the context of the calculation of the *with-profits insurance capital component*, also requires the *actuarial function* to:

(a) advise the *firm's* governing body on the methods and assumptions to be used in the calculation of the *firm's with-profits insurance capital component*;

(b) perform that calculation in accordance with the methods and assumptions determined by the *firm's* governing body; and

(c) report to the *firm's* governing body on the results of that calculation.

(2) *SUP 4* requires the *with-profits actuary* to advise the *firm's* governing body on the discretion exercised by the *firm*. In the context of the calculation of the *with-profits insurance capital component*, *SUP 4* also requires the *with-profits actuary* to advise the *firm's* governing body as to whether the methods and assumptions (including the allowance for management actions) used for that calculation are consistent with the *firm's Principles and Practices of Financial Management (PPFM)* - see *COB 6.10* and with its regulatory duty to treat its *customers* fairly.

General

DEFINITIONS

- 7.4.10 R** In this section, real estate means an interest in land, buildings or other immovable property.
- 7.4.11 R** In this section, the long-term gilt yield is the annualised equivalent of the yield on the 15-year index for United Kingdom Government fixed-interest securities jointly compiled by the Financial Times, the Institute of Actuaries and the Faculty of Actuaries.
- 7.4.12 R** For the purposes of this section, a *firm* has an exposure to an asset or liability where the *firm's* valuation of its assets or liabilities changes when the value of the asset or liability changes.
- 7.4.13 G** In this section, any reference to a *firm's* regulatory duty to treat its *customers* fairly is a reference to the *firm's* duty under PRIN 6 (*Customers' interests*). This states that a *firm* must pay due regard to the interests of its *customers* and treat them fairly.
- 7.4.14 G** In this section, any reference to the *Principles and Practices of Financial Management (PPFM)* is a reference to the requirements in COB 6.10 (Principles and Practices of Financial Management) for *firms* to establish, maintain and record the principles and practices of financial management according to which the business of its *with-profits funds* is conducted.
- 7.4.15 G** The extent to which a *firm* requires a separate *PPFM* for each of its *with-profits funds* will depend on the *firm's* circumstances and any relevant representations made by the *firm* to its with-profits *policyholders*. In this section, any reference to a *firm's PPFM* refers to the *PPFM* which relate to the *with-profits fund* or the *with-profits insurance contracts* in question.

RECORD KEEPING

- 7.4.16 R** A *firm* must make, and retain for an appropriate period of time, a record of:
- (1)** the methods and assumptions used in making any calculation required for the purposes of this section (and any subsequent changes) and the reasons for their use; and
 - (2)** the nature of, reasons for, and effect of, any change in approach.
- 7.4.17 G** PRU 1.4.54R requires *firms* to maintain accounting and other records for a minimum of three years, or longer as appropriate. For the purposes of PRU 7.4.16R, a period of longer than three years will be appropriate for a *firm's long-term insurance business*. In determining an appropriate time period, a *firm* should have regard to:
- (1)** the detailed *rules* and *guidance* on record keeping in PRU 1.4.52G to PRU 1.4.65G;
 - (2)** the nature and term of the *firm's long-term insurance contracts*; and

- (3) any additional provisions or statutory requirements applicable to the *firm* or its records.

7.4.18 R A firm must also identify in the record required to be kept by PRU 7.4.16R changes in practice, in particular changes in those items which will or may be significant in relation to the eventual claim values.

7.4.19 G Some of the changes identified in accordance with *PRU 7.4.18R* may have to be notified to the *firm's customers* in accordance with the *firm's PPFM*.

GENERAL PRINCIPLES FOR ALLOCATING AGGREGATE AMOUNTS

7.4.20 R Where any calculation is required under this section which:

- (1) is to be made in respect of any *with-profits fund* of a *firm*; and
- (2) covers an amount that is otherwise calculated in relation to the *firm* as a whole;

the *firm* must make an allocation of that amount as between all of its funds (including funds which are not *with-profits funds*).

7.4.21 R In any case where:

- (1) *non-profit insurance contracts* are written in any *with-profits fund* of a *firm*; and
- (2) any calculation is required under this section which:
 - (a) is to be made in respect of the *regulatory excess capital* or *realistic excess capital* for the fund; and
 - (b) covers an amount that is otherwise calculated or allocated in relation to the fund as a whole;

the *firm* must make an allocation of the amount in (2)(b) as between the *with-profits insurance contracts* and *non-profit insurance contracts* written in the fund.

Calculation of regulatory excess capital

7.4.22 R A *firm* must calculate the *regulatory excess capital* for each of its *with-profits funds* by deducting B from A, where:

- (4) A is the *regulatory value of assets* of the fund (see *PRU 7.4.23R*); and

(5) B is the sum of:

- (a) the *regulatory value of liabilities* of the fund (see *PRU 7.4.27R*);
- (b) the *long-term insurance capital requirement* in respect of the fund's *with-profits insurance contracts*; and
- (c) the *resilience capital requirement* in respect of the fund's *with-profits insurance contracts*.

REGULATORY VALUE OF ASSETS

- 7.4.23 R (1)** For the purposes of *PRU 7.4.22R(1)*, the *regulatory value of assets* of a *with-profits fund* is equal to the sum of:
- (a) the amount of the fund's *long-term admissible assets*; and
 - (b) the amount of any *implicit items* allocated to that fund;
- less an amount, representing any *non-profit insurance contracts* written in that fund, determined in accordance with (2).
- (2)** Where *non-profit insurance contracts* are written in a *with-profits fund*, the amount representing those contracts is the sum of:
- (a) the *mathematical reserves* in respect of the *non-profit insurance contracts* written in the fund; and
 - (b) the following amounts, to the extent that each of them is covered by the fund's *long-term admissible assets*:
 - (i) an amount in respect of the *non-profit insurance contracts* written in the fund which represents an appropriate allocation of the *firm's long-term insurance capital requirement*; and
 - (ii) an amount in respect of the *non-profit insurance contracts* written in the fund which represents an appropriate allocation of the *firm's resilience capital requirement*.
- 7.4.24 R** In making a determination in accordance with *PRU 7.4.23R(2)*, a *firm* must allocate *long-term admissible assets* of an appropriate nature and term to any *non-profit insurance contracts* written in the *with-profits fund*.

PRU 7.4 With-profits insurance capital component

- 7.4.25 G In calculating the amount of a *firm's resilience capital requirement* allocated to the *non-profit insurance contracts* in the *with-profit fund* the *firm* should calculate the amount of resilience capital that would be required if that business were in a standalone company owning the assets allocated. The *resilience capital requirement* for the *with-profits insurance business* should also be calculated as if it were a standalone company. An allocation of the *firm's total resilience capital requirement* should then be made in a manner that would produce a result materially consistent with an allocation in proportion to the amounts calculated for each part of the business as standalone entities.
- 7.4.26 G A *firm* needs to obtain an *implicit item waiver* from the FSA in order to bring in an amount under PRU 7.4.23R(1)(b). For guidance on applying for an *implicit item waiver* in respect of future surpluses relating to *with-profit funds* see PRU 2.2 Annex 2G. The amount of any *implicit item* allocated to a *with-profits fund* may be defined in the terms of any *waiver* granted.

REGULATORY VALUE OF LIABILITIES

- 7.4.27 R For the purposes of PRU 7.4.22R(2)(a), the ***regulatory value of liabilities of a with-profits fund*** is equal to the sum of:
- (1) the ***mathematical reserves (after distribution of surplus) in respect of the fund's with-profits insurance contracts; and***
 - (2) the ***regulatory current liabilities of the fund (see PRU 7.4.29R).***
- 7.4.28 G In PRU 7.4.27R(1), *mathematical reserves* (after distribution of surplus) in relation to a *with-profits fund* are *mathematical reserves* which include provision for the costs of paying any bonuses allocated to the fund's *policyholders* at the *actuarial valuation date* out of surplus arising at the *actuarial valuation date*.
- 7.4.29 R For the purposes of PRU 7.4.27R(2), the ***regulatory current liabilities of a with-profits fund*** are equal to the sum of the following amounts to the extent that they relate to that fund:
- (1) ***accounting liabilities (including long-term insurance liabilities which have fallen due before the end of the financial year);***
 - (2) ***liabilities from deposit back arrangements; and***
 - (3) ***any provision for adverse variations (determined in accordance with PRU 4.3.18R).***
- 7.4.30 G The amount of *regulatory current liabilities* for a *with-profits fund* refers to the sum of the amounts in (1) and (2) in respect of the fund:
- (1) the amount of 'Total other insurance and non-insurance liabilities'; and
 - (2) the amount of 'Cash bonuses which had not been paid to *policyholders* prior to the end of the financial year';

as disclosed at lines 49 and 12 respectively of the appropriate Form 14 ('Long-term business liabilities and margins') for that fund as part of the Annual Returns required to be deposited with the FSA under *IPRU(INS)* rule 9.6(1).

Calculation of realistic excess capital

7.4.31 R A firm must calculate the *realistic excess capital* for each of its *with-profits funds* by deducting B from A, where:

- (1) A is the *realistic value of assets* of the fund (see *PRU 7.4.32R*);
and
- (2) B is the sum of:
 - (a) the *realistic value of liabilities* of the fund (see *PRU 7.4.38R*);
and
 - (b) the *risk capital margin* for the fund (see *PRU 7.4.41R*).

REALISTIC VALUE OF ASSETS

7.4.32 R (1) For the purposes of *PRU 7.4.31R*(1), the *realistic value of assets* of a *with-profits fund* is the sum of:

- (a) the amount of the fund's *regulatory value of assets* determined in accordance with *PRU 7.4.23R*, but with no value given to any *implicit item* and excluding the regulatory value of any *shares* in a *related insurance undertaking* which carries on *long-term insurance business*;
 - (b) the amount of the fund's excess *admissible assets* (see *PRU 7.4.35R*);
 - (c) the present value of future profits (or losses) on any *non-profit insurance contracts* written in the *with-profits fund* (see *PRU 7.4.36R*);
 - (d) the market value of any *derivative* or *quasi-derivative* held in the fund (see *PRU 1.3.12R* to *PRU 1.3.31R*) to the extent its value is not reflected in (a), (b) or (c);
 - (e) any amount determined under (2); and
 - (f) the amount of any prepayments made from the fund.
- (2) Where any equity *shares* held (directly or indirectly) by a *firm* (A):

- (a) are *shares* in a *related insurance undertaking* (B) of A which carries on *long-term insurance business*; and
- (b) have been identified by A under *PRU 7.4.20R* as *long-term insurance assets* which are held in the *with-profits fund* for which the realistic value is to be determined under (1);

the amount required under (1)(e) is the relevant proportion of the value of all B's equity *shares* as determined in (3).

(3) For the purposes of (2):

- (a) the relevant proportion is the proportion of the total number of B's *shares* that is held (directly or indirectly) by A;
- (b) the value of all B's equity *shares* must be taken as D deducted from C, where C is equal to the sum of:
 - (i) the shareholder net assets of B;
 - (ii) any surplus assets in the non-profit funds of B;
 - (iii) any additional amount arising from the excess of the present value of future profits (or losses) on any *non-profit insurance contracts* written by B (calculated on a basis consistent with *PRU 7.4.36R*), excluding any amount arising from business that is written in a *with-profits fund*, over any present value of future profits (or losses) used in calculating B's regulatory capital requirements and arising from business outside its *with-profits funds*; and
 - (iv) where B has any *with-profits funds*, the present value of projected future transfers out of those funds to shareholder funds of B;

and D is equal to the sum of:

- (v) the *long-term insurance capital requirement* in respect of any *non-profit insurance contracts* written in a non-profit fund of B;
- (vi) the amount of the *resilience capital requirement* in respect of any business written in a non-profit fund of B; and

- (vii) any part of the *with-profits insurance capital component* of B, to the extent that this is not covered from the assets of the *with-profits fund* from which it arises after deducting from those assets the amount calculated under (iv).

(4) The methods and assumptions used in the calculations under (3)(b) (iii) and (iv) must follow a consistent approach to that set out in *PRU 7.4.36R*.

- 7.4.33 G In *PRU 7.4.32R(1)(d)*, where a *derivative* or *quasi-derivative* has a positive asset value, credit should be given within the *realistic value of assets*. If the *derivative* or *quasi-derivative* has a negative asset value it should be valued within realistic liabilities as an element of *realistic current liabilities* (see *PRU 7.4.38R(3)*).
- 7.4.34 G Where a *firm* identifies shares in a *related insurance undertaking* which carries out life insurance business as shares held in one of its *with-profits funds*, *PRU 7.4.32R(1)(e)*, (2) and (3) brings in a realistic valuation of the *related insurance undertaking* equal to its net assets plus the present value of future profits, less its regulatory capital requirements. Where the *related insurance undertaking* has taken the present value of future profits arising from its contracts into consideration in covering its regulatory capital requirements (for example, its *risk capital margin*, under *PRU 7.4.43R(2)(b)*), *PRU 7.4.32R(3)(b)(iii)* requires a *firm* to exclude those future profits in valuing the *related insurance undertaking*.
- 7.4.35 R **Excess *admissible assets* of a *with-profits fund* means *admissible assets* which exceed the exposure or percentage limits referred to in *PRU 3.2.25R* to *PRU 3.2.46G*.**
- 7.4.36 R **A *firm* must calculate the present value of future profits (or losses) on *non-profit insurance contracts* written in the *with-profits fund* using methodology and assumptions which:**
- (1) are based on current estimates of future experience;
 - (2) involve reasonable (but not excessively prudent) adjustments to reflect risk and uncertainty;
 - (3) allow for a market-consistent valuation of any guarantees or options within the contracts valued;
 - (4) are derived from current market yields;
 - (5) have regard to generally accepted actuarial best practice and generally accepted industry standards appropriate for *firms* carrying on *long-term insurance business*;
 - (6) are consistent with the allocation, made in accordance with *PRU 7.4.21R*, of any aggregate amounts as between the *with-profits insurance contracts* and the *non-profit insurance contracts* written in the fund;

- (7) allow for any tax that would be payable out of the *with-profits fund* in respect of the contracts valued; and
- (8) are consistent with the allocation, made in accordance with *PRU 7.4.24R*, of *long-term admissible assets* as between the *with-profits insurance contracts* and any *non-profit insurance contracts* written in the fund.

7.4.37 G In calculating the present value of future profits (or losses) for *non-profit insurance business* required by *PRU 7.4.32R(1)(c)*, a *firm* may take into consideration any release into surplus of the *long-term insurance capital requirement* and the *resilience capital requirement* as the relevant *policies* go off the books.

REALISTIC VALUE OF LIABILITIES: GENERAL

7.4.38 R For the purposes of *PRU 7.4.31R(2)(a)*, the *realistic value of liabilities* of a *with-profits fund* is the sum of:

- (1) the *with-profits benefits reserve* of the fund;
- (2) the *future policy related liabilities* of the fund; and
- (3) the *realistic current liabilities* of the fund.

7.4.39 G All liabilities arising under, or in connection with, *with-profits insurance contracts* written in the fund should be included in the *realistic value of liabilities* referred to in *PRU 7.4.38R*, including those in respect of guarantees and the value of options.

7.4.40 G Detailed *rules* and *guidance* for the calculation of the three elements referred to in *PRU 7.4.38R* are contained below in this section:

- (1) *PRU 7.4.113R* to *PRU 7.4.133R* refer to the *with-profits benefits reserve*;
- (2) *PRU 7.4.134G* to *PRU 7.4.187G* refer to the *future policy related liabilities*; and
- (3) *PRU 7.4.188R* refers to the *realistic current liabilities*.

RISK CAPITAL MARGIN

7.4.41 R (1) A *firm* must calculate a *risk capital margin* for each of its *with-profits funds* in accordance with (2) to (5).

(2) The *firm* must identify relevant assets (see *PRU 7.4.43R*) which, in the most adverse scenario, will have a value (see *PRU 7.4.44R*) which is equal to the *realistic value of liabilities* of the fund under that scenario.

- (3) The most adverse scenario means the single event comprising that combination of the scenarios in *PRU 7.4.42R* which gives rise to the largest positive value that results from deducting B from A, where:
 - (a) A is the value of relevant assets which will produce the result described in (2); and
 - (b) B is the realistic value of liabilities of the fund.
- (4) The *risk capital margin* for the fund is the result of deducting C from A, where C is the sum of:
 - (a) B; and
 - (b) any amount included within relevant assets under *PRU 7.4.43R(2)(c)*.
- (5) In calculating the value of relevant assets for the purpose of determining the most adverse scenario in (3), a *firm* must not adjust the valuation of any asset taken into consideration under *PRU 7.4.32R(1)(e)* (*related insurance undertakings*) or *PRU 7.4.43R(2)(c)* (present value of future profits arising from business outside the *with-profits fund*).

- 7.4.42 R** For the purposes of *PRU 7.4.41R(3)*, the scenarios are one scenario selected from each of the following:
- (1) in respect of UK and other assets within *PRU 7.4.60R(1)(a)*:
 - (a) the range of *market risk* scenarios identified in accordance with *PRU 7.4.65R(1)(a)* (equities);
 - (b) the range of *market risk* scenarios identified in accordance with *PRU 7.4.65R(1)(b)* (real estate); and
 - (c) the range of *market risk* scenarios identified in accordance with *PRU 7.4.65R(1)(c)* (fixed interest securities);
 - (2) in respect of non-UK assets within *PRU 7.4.60R(1)(b)*:
 - (a) the range of *market risk* scenarios identified in accordance with *PRU 7.4.70R(1)(a)* (equities);
 - (b) the range of *market risk* scenarios identified in accordance with *PRU 7.4.70R(1)(b)* (real estate); and
 - (c) the range of *market risk* scenarios identified in accordance with *PRU 7.4.70R(1)(c)* (fixed interest securities);
 - (3) the range of *credit risk* scenarios identified in accordance with *PRU 7.4.75R(1)* (bond or debt items);

- (4) the range of *credit risk* scenarios identified in accordance with *PRU 7.4.75R(2)* (*reinsurance* items or analogous non-*reinsurance* financing agreements including *derivatives* and *quasi-derivatives*);
- (5) the range of *credit risk* scenarios identified in accordance with *PRU 7.4.75R(3)* (other items); and
- (6) the persistency risk scenario identified in accordance with *PRU 7.4.97R*.

- 7.4.43 R (1) In *PRU 7.4.41R*, in relation to a *with-profits fund*, the relevant assets means a range of assets which meets the following conditions:
- (a) the range is selected on a basis which is consistent with the *firm's* regulatory duty to treat its *customers* fairly;
 - (b) the range must include assets from within the *with-profits fund* the value of which is greater than or equal to the *realistic value of liabilities* of the fund;
 - (c) the range is selected in accordance with (2); and
 - (d) no asset of the *firm* may be allocated to the range of assets identified in respect of more than one *with-profits fund*.
- (2) The range of assets may be selected only from the following assets and must be selected in the following order:
- (a) assets that have a realistic value under *PRU 7.4.32R*;
 - (b) if a *firm* has selected all the assets within (a), any *admissible assets* not identified as held within the *with-profits fund* (up to the sum of the *firm's* shareholder net assets and any surplus assets in the *firm's* non-profit funds to the extent not required to meet any regulatory capital requirements in respect of business written outside the fund and subject to the maximum limit imposed by (3)); and
 - (c) if a *firm* has selected all the assets within (a) and (b), any additional assets not exceeding 50% of the present value of future profits arising from the *insurance contracts* written by the *firm* outside its *with-profits funds*, but subject to the maximum limit imposed by (4).

- (3) Where a *firm* has more than one *with-profits fund*, the sum of the the amounts brought into account under (2)(b) for each *with-profits fund* must not in aggregate exceed the sum of the *firm's* shareholder net assets and the surplus assets in its non-profit funds less any regulatory capital requirements in respect of business written outside its *with-profits funds*.
- (4) Where a *firm* has more than one *with-profits fund*, the sum of the the amounts brought into account under (2)(c) for each *with-profits fund* must not in aggregate exceed 50% of the present value of future profits arising from *insurance contracts* written by the *firm* outside its *with-profits funds*.

7.4.44 R In valuing the relevant assets identified under *PRU 7.4.41R(2)*, a *firm* must use the same methods of valuation as in *PRU 7.4.32R*, except that:

- (1) the value of any *admissible assets* not identified as held within the *with-profits fund* (see *PRU 7.4.43(2)(b)*) must be as determined under *PRU 1.3*; and
- (2) the value of any asset which forms part of the range of assets as a result of *PRU 7.4.43R(2)(c)* must be determined on a basis consistent with that described in *PRU 7.4.36R*.

7.4.45 G The purpose of the *risk capital margin* for a *with-profits fund* is to cover adverse deviation from:

- (1) the fund's *realistic value of liabilities*;
- (2) the value of assets identified, in accordance with *PRU 7.4.41R(2)*, to cover the amount in (1) and the fund's *risk capital margin*;

arising from the effects of *market risk*, *credit risk* and persistency risk. Other risks are not explicitly addressed by the *risk capital margin*.

7.4.46 G The amount of the *risk capital margin* calculated by the *firm* for a *with-profits fund* will depend on the *firm's* choice of assets held to cover the fund's *realistic value of liabilities* and the margin. *PRU 7.4.41R* requires the relevant assets to be sufficient, in the most adverse scenario, to cover the *realistic value of liabilities* in the event that scenario was to arise.

7.4.47 G *PRU 7.4.43R(2)(b)* allows *firms* to bring the economic value of *non-profit insurance business* written outside a *with-profits fund* into the assets available to cover the *risk capital margin*. To place a prudent limit on the amount of future profits taken into consideration a maximum of 50% of the present value of *non-profit insurance business* can be taken into the calculation. Where a contract is written in a non-profit fund but the assets arising from that contract are invested in a *with-profit fund* which is subject to charges for investment management or other services which benefit the non-profit fund, such charges can be taken into consideration in calculating the present value of future profits of the *non-profit insurance business*. Where a proportion of the present value of future profits on *non-profit insurance business* written outside a *with-profits fund* is brought in as an asset, no stress tests apply to this asset (see *PRU 7.4.41R(5)*) as the amount taken into consideration is limited to 50% of the total present value.

PRU 7.4 With-profits insurance capital component

- 7.4.48 G A *firm* using a stochastic approach in *PRU 7.4.167R(1)*, should keep recalibration in the post-stress scenarios to the minimum required to reflect any change in the underlying risk-free yields. A *firm* using the market costs of hedging approach, as in *PRU 7.4.167R(2)*, may assume in estimating the market cost of hedging in the post-stress scenarios that market volatilities are unchanged.
- 7.4.49 G In the scenario tests set out in *PRU 7.4.59R* to *PRU 7.4.99R* *firms* are required to test for worst case scenarios across a range of assumptions. The tests are, with the exception of the *credit risk* test, two-sided, requiring both increases and decreases in the assumptions. The *FSA* does not expect a *firm* to investigate every possible stress, but a *firm* should be able to demonstrate that it is reasonable to assume that it has successfully identified the single event that determines the *risk capital margin* for the *firm's* business, as required by *PRU 7.4.41R(3)*.

MANAGEMENT ACTIONS

- 7.4.50 R In calculating the *risk capital margin* for a *with-profits fund*, a *firm* may reflect, in its projections of the value of assets and liabilities under the scenarios in *PRU 7.4.42R*, the *firm's* prospective management actions (see *PRU 7.4.51R*).
- 7.4.51 R Prospective management actions refer to the foreseeable actions that would be taken by the *firm's* management, taking into account:
- (1) an appropriately realistic period of time for the management actions to take effect; and
 - (2) the *firm's* *PPFM* and its regulatory duty to treat its *customers* fairly.
- 7.4.52 G The management actions in *PRU 7.4.51R* may include, but are not limited to, changes in future bonus rates, reductions in *surrender values*, changes in asset dispositions (taking into account the associated selling costs) and changes in the amount of charges deducted from *asset shares* for *with-profits insurance contracts*.
- 7.4.53 G A *firm* should use reasonable assumptions in incorporating management actions into its projections of claims such that the mitigating effects of the management actions are not overstated. In modelling management actions, a *firm* should ensure consistency with its *PPFM* and take into account its regulatory duty to treat its *customers* fairly.
- 7.4.54 G In accordance with *PRU 7.4.16R*, a *firm* should make and retain a record of the approach used, in particular the nature and effect of anticipated management actions (including, where practicable, the amount by which the actions would serve to reduce the projected values of assets and liabilities).
- 7.4.55 G A *firm* which deducts charges in respect of any adverse experience or cost of capital to *with-profits insurance contracts* should keep a record under *PRU 7.4.16R* of the amount of any such charges to its *customers* and of how it has ensured their fair treatment.

POLICYHOLDER ACTIONS

- 7.4.56 R** In calculating the *risk capital margin* for a *with-profits fund*, a *firm* must reflect, in its projections of the value of assets and liabilities under the scenarios in *PRU 7.4.42R*, a realistic assessment of the actions of its *policyholders* (see *PRU 7.4.57R*).
- 7.4.57 R** *Policyholder* actions refer to the foreseeable actions that would be taken by the *firm's policyholders*, taking into account:
- (1)** the experience of the *firm* in the past; and
 - (2)** the changes that may occur in the future if options and guarantees become more valuable to *policyholders* than in the past.
- 7.4.58 G** A *firm* should use reasonable assumptions in incorporating *policyholder* actions into its projections of *claims* such that any mitigating effects of *policyholder* actions are not overstated and any exacerbating effects of *policyholder* actions are not understated. In modelling *policyholder* actions, a *firm* should ensure consistency with its *PPFM* and take into account its regulatory duty to treat its *customers* fairly in determining the options and information that would be available to *policyholders*.
- 7.4.59 G** In calculating the persistency scenario in *PRU 7.4.97R*, a *firm* needs to make assumptions regarding the future termination rates exhibited by *policies*, at points described in particular in *PRU 7.4.98R*. Such assumptions should be realistic. However, the *firm* must have regard to the economic scenarios being projected. For example, if the value of an option became significantly greater in a future scenario than in the recent past, then the behaviour of *policyholders* in taking up the option is likely to differ in this future scenario compared with the recent past.

MARKET RISK SCENARIO

- 7.4.60 R** **(1)** For the purposes of *PRU 7.4.42R* the ranges of *market risk* scenarios that a *firm* must assume are:
- (a)** for exposures to UK assets and for exposures to non-UK assets within **(2)**, the ranges of scenarios set out in *PRU 7.4.65R*; and
 - (b)** for exposures to other non-UK assets, the ranges of scenarios set out in *PRU 7.4.70R*.
- (2)** The exposures to non-UK assets within this paragraph are:
- (a)** exposures which do not arise from a significant territory outside the *UK* (see *PRU 7.4.61R*); or

- (b) exposures which do arise from a significant territory outside the *UK* but which represent less than 0.5% of the *firm's long-term insurance assets*, measured by *market value*.

7.4.61 R For the purposes of this section in relation to a *with-profits fund*, a significant territory is any country or territory in which more than 2.5% of the fund's *realistic value of assets (by market value)* are invested.

7.4.62 G In contrast to the calculation of the *resilience capital requirement* for the *firm* (see *PRU 4.2.10G* to *PRU 4.2.27R*), for the *market risk* scenarios in *PRU 7.4.65R* and *PRU 7.4.70G* a *firm* may reflect management actions and must make a realistic assessment of *policyholder* actions in projecting the assets and liabilities in its calculation of the *risk capital margin* for a *with-profits fund* within the *firm*.

7.4.63 G In *PRU 7.4.60R* to *PRU 7.4.73G*, where there is reference to exposure to assets invested in a territory this should be interpreted as follows:

- (1) for equities, a stock that is listed on a stock market in that territory or, if unlisted, the stock of a *company* that is incorporated in that territory;
- (2) for bonds, one that is denominated in the currency of that territory, or issued by an institution incorporated in that territory;
- (3) for real estate, a property that is located in that territory; and
- (4) for *derivatives*, *quasi-derivatives* and other instruments, one where the assets to which the instrument is exposed are assets invested in that territory.

In *PRU 7.4.60R* to *PRU 7.4.73G*, a preference share should be subjected to the same stress tests as an equity share.

7.4.64 G The relevant assets identified under *PRU 7.4.40R(2)* to calculate the *risk capital margin* may, in certain circumstances, include up to 50% of the present value of future profits arising from *insurance contracts* written by the *firm* outside its *with-profits funds*. *PRU 7.4.41R(5)* exempts such an asset from the *market risk* stress tests.

MARKET RISK SCENARIO FOR EXPOSURES TO UK ASSETS AND CERTAIN NON-UK ASSETS

7.4.65 R The range of *market risk* scenarios referred to in *PRU 7.4.60R(1)(a)* is:

- (1) a rise or fall in the *market value* of equities of up to the greater of:
 - (a) 10%; and
 - (b) 20%, less the *equity market adjustment ratio* (see *PRU 7.4.68R*);
- (2) a rise or fall in real estate values of up to 12.5%; and

- (3) a rise or fall in yields on all fixed interest securities of up to 17.5% of the long-term gilt yield.

7.4.66 R For the purposes of *PRU 7.4.65R(1),(2)* and (3), a *firm* must:

- (1) assume that yields on equities and real estate remain unchanged from those applicable at market levels before applying each scenario; and
- (2) model a rise or fall in equity, real estate and fixed interest markets as if the movement occurred instantaneously.

7.4.67 G Where the long-term gilt yield is 6%, a change of 17.5% in that yield would amount to a change of 1.05 percentage points. For the purpose of the scenarios in *PRU 7.4.65R(3)*, the *firm* would assume a fall or rise of up to 1.05 percentage points in yields on all fixed interest securities.

EQUITY MARKET ADJUSTMENT RATIO

7.4.68 R The *equity market adjustment ratio* referred to in *PRU 7.4.65(1)(b)* is:

- (1) if the ratio calculated in (a) and (b) lies between 80% and 100%, the result of 100% less the ratio (expressed as a percentage) of:
 - (a) the current value of the FTSE Actuaries All Share Index; to
 - (b) the average value of the FTSE Actuaries All Share Index over the preceding 90 calendar days;
- (2) 0%, if the ratio calculated in (1)(a) and (b) is more than 100%; and
- (3) 20%, if the ratio calculated in (1)(a) and (b) is less than 80%.

7.4.69 R In *PRU 7.4.68R(1)(b)*, the average value of the FTSE Actuaries All Share Index over any period of 90 calendar days means the arithmetic mean based on levels at the close of business on each of the days in that period on which the London Stock Exchange was open for trading.

MARKET RISK SCENARIO FOR EXPOSURES TO OTHER NON-UK ASSETS

7.4.70 R The range of *market risk* scenarios referred to in *PRU 7.4.60R(1)(b)* is:

- (1) an appropriate rise or fall in the *market value* of equities listed in that territory (see *PRU 7.4.72R*), which must be at least equal to the percentage determined in *PRU 7.4.65R(1)(a)*;

- (2) a rise or fall in real estate values in that territory of up to 12.5%; and
- (3) a rise or fall in yields on all fixed interest securities of up to 17.5% of the nearest equivalent (in respect of the method of calculation) of the long term gilt yield.

7.4.71 R For the purposes of *PRU 7.4.70R(1)*, (2) and (3) a *firm* must:

- (1) assume that yields on equities and real estate remain unchanged from those applicable at market levels before applying each scenario; and
- (2) model a rise or fall in equity, real estate and fixed interest markets as if the movement occurred instantaneously.

7.4.72 R For the purposes of *PRU 7.4.70R(1)*, an appropriate rise or fall in the *market value* of equities to which a *firm* has exposure in a significant territory must be determined having regard to:

- (1) an appropriate equity market index for that territory; and
- (2) the historical volatility of the equity market index selected in (1).

7.4.73 G For the purpose of *PRU 7.4.72R(1)*, an appropriate equity market index (or indices) for a territory should be such that:

- (1) the constituents of the index (or indices) are reasonably representative of the nature of the equities to which the *firm* is exposed in that territory which are included in the range of assets identified in accordance with *PRU 7.4.41R(2)*; and
- (2) the frequency of, and historical data relating to, published values of the index (or indices) are sufficient to enable an average value(s) and historical volatility of the index (or indices) to be calculated over at least the three preceding *financial years*.

CREDIT RISK SCENARIOS

GENERAL

7.4.74 G (1) The purpose of the *credit risk* scenarios in *PRU 7.4.75R* to *PRU 7.4.96G* is to show the financial effect of specified changes in the general *credit risk* environment on a *firm's* direct (counterparty) and indirect *credit risk* exposures. The scenarios apply in relation to corporate bonds, debt, *reinsurance* and other exposures, including *derivatives* and *quasi-derivatives*. This is thus quite separate from any reference to allowance for *credit risk* in *PRU 4.2*.

PRU 7.4 With-profits insurance capital component

- (2) In the case of bonds and debts, the scenarios are described in terms of an assumed credit rating dependent on the widening of credit spreads - changes in bond and debt credit spreads will have a direct impact on the value of bond and debt assets. Credit ratings are intended to give an indication of the security of the income and capital payments for a bond – the higher the credit rating, the more secure the payments. The reaction of credit spreads to developments in markets for *credit risk* varies by credit rating and so the scenarios to be assumed for bonds and debts depend on their ratings. The credit spreads on bonds and debt represent compensation to the investor for the risk of default and downgrade, but also for illiquidity, price volatility and the uncertainty of recovery rates relative to government bonds. Credit spreads on bonds tend to widen during an economic recession to reflect the increased expectations that corporate borrowers may default on their obligations or be subject to rating downgrades.
- (3) Changes in bond and debt credit spreads will also be indicative of a change in direct counterparty exposure in relation to *reinsurance* and other exposures including *derivatives* and *quasi-derivatives*.
- (4) In addition, changes in bond and debt credit spreads may indirectly impact on credit exposures, for example by affecting the payments anticipated under credit derivative instruments.
- (5) A *firm* will also need to allow for the effect of other components of the single event comprising the combination of scenarios applicable under PRU 7.4.41R in assessing exposure to *credit risk*. For example, in the case of an equity put option and a fall in equity market values, the resulting increase in the level of exposure to the *firm's* counterparty for the option combined with a change in the quality of the counterparty should be allowed for.

7.4.75 R For the purposes of PRU 7.4.42R the range of *credit risk* scenarios that a *firm* must assume is:

- (1) changes in value resulting from an increase in credit spreads by an amount of up to the spread stress determined according to PRU 7.4.81R in respect of any bond or debt item; and**
- (2) changes in value determined according to PRU 7.4.91R in respect of any *reinsurance* item or any analogous non-*reinsurance* financing agreement item; and**
- (3) changes in value determined according to PRU 7.4.95R for any other item (including any *derivative* or *quasi-derivative*).**

7.4.76 R For the purposes of PRU 7.4.75R a *firm* must make appropriate allowance for any loss mitigation techniques to the extent that they are loss mitigation techniques relied on for the purpose of PRU 3.2.10R in accordance with PRU 3.2.19R and PRU 3.2.21R.

7.4.77 G The change in asset or liability values to be determined in relation to a *credit risk* scenario for the purposes of PRU 7.4.41R and PRU 7.4.42R is the change in value which would arise on the occurrence of the relevant *credit risk* scenario as a result of bond, debt, *reinsurance* or other exposures whether or not there is a direct counterparty exposure.

- 7.4.78 R** Where a bond or a debt item or *reinsurance* asset is currently in default, a *firm* may leave it out of account when carrying out the calculation required by **PRU 7.4.75R**.
- 7.4.79 G** Where a bond or a debt item or a *reinsurance* asset is currently in default and has been specifically provisioned, in accordance with relevant accounting standards, a *firm* is not required to increase the existing default provisions to reflect a worsening of recovery rates.
- 7.4.80 R** Where the *credit risk* scenarios in **PRU 7.4.75R** to **PRU 7.4.96G** require a *firm* to assume a change in current credit spread, or a direct change in market value, the *firm* must not change the risk-free yields used to discount future cash flows in calculating the revised *realistic value of liabilities* and *realistic value of assets* (see **PRU 7.4.41R(2)**) resulting from those *credit risk* scenarios.

SPREAD STRESSES TO BE ASSUMED FOR BONDS AND DEBT

- 7.4.81 R** (1) In **PRU 7.4.75R(1)** the spread stress which a *firm* must assume for any bond or debt item is:
- (a) for any bond or debt item issued or guaranteed by an organisation which is in accordance with **PRU 7.4.84R** a *credit risk* scenario exempt organisation in respect of that item, zero basis points; and
 - (b) for any other bond or debt item:
 - (i) Y if the credit rating description of that other bond or debt item determined by reference to **PRU 7.4.86R** is not "Highly speculative or very vulnerable"; and
 - (ii) otherwise the larger of Y and Z.
- (2) For the purpose of (1)(b):
- (a) Y is the product of the spread factor for that bond or debt item and the square root of S, where:
 - (i) the spread factor for a bond or debt item is the spread factor shown in the final column of Table **PRU 7.4.87R**, in the row of that Table corresponding to the credit rating description of the bond or debt item determined for the purpose of this *rule* by reference to **PRU 7.4.86R**; and

(ii) subject to (3), *S* is the current credit spread for a bond or debt item, expressed as a number of basis points, which the *firm* must determine as the current yield on the bond or debt item in excess of the current gross redemption yield on the government bond most similar to that bond or debt item in terms of currency of denomination and equivalent term; and

(b) *Z* is the change in credit spread expressed as a number of basis points that would result in the current market value of the bond or debt falling by 5%.

(3) Where, for the purposes of (2)(a)(ii), there is no suitable government bond, the *firm* must use its best estimate of the gross redemption yield that would apply for a notional government bond similar to the bond or debt item in terms of currency of denomination and equivalent term.

7.4.82 R For the purpose of PRU 7.4.81R(1)(a) a guarantee must be direct, explicit, unconditional and irrevocable.

- 7.4.83 G**
- (1) As an example, a bond item has the credit rating description "exceptional or extremely strong" and currently yields 49 basis points in excess of the most similar government bond. The spread factor for that bond item is 3.00 by reference to Table PRU 7.4.87R. Since *S* is 49, the square root of *S* is 7 and the spread stress for that item is 3.00 times 7 i.e. 21 basis points. The *firm* must consider the impact of an increase in spreads by up to 21 basis points for that item.
 - (2) As a further example, a bond item has credit rating description "highly speculative or very vulnerable". For this bond, *S* is 400, being the current spread for that bond expressed as a number of basis points. The spread factor for the bond is 24.00. So the *firm* must consider the impact of an increase in spreads by up to 24.00 times 20 i.e. 480 basis points for that item. The bond is however of short duration and the reduction in market value resulting from an additional spread of 480 basis points is less than 5 per cent of its current market value. A 5 per cent reduction in its market value would result from a spread widening of 525 basis points. The *firm* must consider the impact of an increase in spreads by up to 525 basis points for that item by virtue of its credit rating description.
 - (3) In arriving at the estimated gross redemption yield in PRU 7.4.81R(3) the *firm* may have regard to any appropriate swap rates for the currency of denomination of the bond or debt item, adjusted to take appropriate account of observed differences between swap rates and the yields on government bonds.

7.4.84 R For the purposes of this section:

- (1) an organisation is a *credit risk* scenario exempt organisation in respect of an item if the organisation is :
 - (a) the European Central Bank; or

- (b) **any central government or central bank which, in relation to that item, satisfies the conditions in (2); or**
 - (c) **a multilateral development bank which is listed in (3); or**
 - (d) **an international organisation which is listed in (4);**
- (2) the conditions in (1)(b) are that, for any claim against the central government or central bank denominated in the currency in which the item is denominated:**
 - (a) **a credit rating is available from at least one listed rating agency nominated in accordance with *PRU 7.4.89R*; and**
 - (b) **the credit rating description in the first column of Table *PRU 7.4.87R* corresponding to the lowest such credit rating is either "exceptionally or extremely strong" or "very strong";**
- (3) for the purposes of (1)(c) the listed multilateral development banks are:**
 - (a) **the International Bank for Reconstruction and Development;**
 - (b) **the International Finance Corporation;**
 - (c) **the Inter-American Development Bank;**
 - (d) **the Asian Development Bank;**
 - (e) **the African Development Bank;**
 - (f) **the Council of Europe Development Bank;**
 - (g) **the Nordic Investment Bank;**
 - (h) **the Caribbean Development Bank;**
 - (i) **the European Bank for Reconstruction and Development;**
 - (j) **the European Investment Bank; and**
 - (k) **the European Investment Fund;**
- (4) for the purposes of (1)(d) the listed international organisations are:**
 - (a) **the European Community;**
 - (b) **the International Monetary Fund; and**
 - (c) **the Bank for International Settlements.**

- 7.4.85 G In considering claims on or guaranteed by a central government or central bank, the currency in which the claim is denominated needs to be taken into account (see *PRU 7.4.84R(2)*). It is possible, for example, that a given central bank would be a *credit risk* scenario exempt organisation in respect of claims on it denominated in its domestic currency, while not being a *credit risk* scenario exempt organisation in respect of claims on it denominated in a currency other than its domestic currency – the central government or central bank may have been assigned different credit assessments depending on the currency in which the claim on it is denominated.
- 7.4.86 R **(1) For the purposes of this section the credit rating description of a bond or debt item is to be determined in accordance with (2) and (3).**
- (2) If the item has at least one credit rating nominated in accordance with *PRU 7.4.89R* ("a rated item") its credit rating description is:**
- (a) **where it has only one nominated credit rating, the general description given in the first column of Table *PRU 7.4.87R* corresponding to that rating; or**
- (b) **where it has two or more nominated credit ratings and the two highest nominated ratings fall within the same general description given in the first column of that Table, that description; or**
- (c) **where it has two or more nominated credit ratings and the two highest nominated ratings do not fall within the same general description given in the first column of that Table, the second highest of those two descriptions.**
- (3) If the item is not a rated item, its credit rating description is the general description given in the first column of Table *PRU 7.4.87R* that most closely corresponds to the *firm's* own assessment of the item's credit quality.**
- (4) An assessment under (3) must be made by the *firm* for the purposes of the *credit risk* scenario having due regard to the seniority of the bond or debt and the credit quality of the bond or debt issuer.**

7.4.87 R Table : Listed rating agencies, credit rating descriptions, spread factors

Listed rating agencies					Spread Factor
Credit Rating Description					
Exceptional or extremely strong	aaa	AAA	Aaa	AAA	3.00
Very strong	aa	AA	Aa	AA	5.25
Strong	a	A	A	A	6.75
Adequate	bbb	BBB	Baa	BBB	9.25
Speculative or less vulnerable	bb	BB	Ba	BB	15.00
Very speculative or more vulnerable	b	B	B	B	24.00
Highly speculative or very vulnerable	Below b	Below B	Below B	Below B	24.00

7.4.88 G Where listed rating agencies provide ratings by sub-category then all ratings should be allocated to the main ratings category (e.g. ratings sub-category A+ or A- would be allocated to the assigned ratings category "Strong").

7.4.89 R For the purposes of PRU 7.4.84R and PRU 7.4.86R, a *firm* may, subject to (1) to (5), nominate for use credit ratings produced by one or more of the rating agencies listed in PRU 7.4.90R:

- (1) if the *firm* decides to nominate for use for an item the credit rating produced by one or more rating agencies, it must do so consistently for all similar items;

- (2) the *firm* must use credit ratings in a continuous and consistent way over time;
- (3) the *firm* must nominate for use only credit ratings that take into account both principal and interest;
- (4) if the *firm* nominates for use credit ratings produced by one of the listed rating agencies then the *firm* must use solicited credit ratings produced by that listed rating agency; and
- (5) the *firm* may nominate for use unsolicited credit ratings produced by one or more of the listed rating agencies except where there are reasonable grounds for believing that any unsolicited credit ratings produced by the agency are used so as to obtain inappropriate advantages in the relationship with rated parties.

7.4.90 R In this section, a listed rating agency is:

- (1) A.M. Best Company;
- (2) FITCH IBCA;
- (3) Moody's Investors Service; or
- (4) Standard & Poor's Corporation.

CREDIT RISK SCENARIO FOR REINSURANCE

- 7.4.91 R (1) The contracts of *reinsurance* or analogous non-*reinsurance* financing agreements to which *PRU 7.4.75R(2)* applies are those
- (a) into which the *firm* has entered;
 - (b) which represent an economic asset under the single event applicable under *PRU 7.4.41R(3)*; and
 - (c) which are material (individually or in aggregate).
- (2) For the purposes of (1), no account is to be taken of *reinsurance* or analogous non-*reinsurance* financing arrangements between *undertakings* in the same *group* where:
- (a) the ceding and accepting *undertakings* are regulated by the *FSA* or a regulatory body in a *designated state or territory* for insurance (including *reinsurance*); and

- (b) **no subsequent cessions of the ceded risk which are material (individually or in aggregate) are made to subsequent accepting *undertakings* by accepting *undertakings* (including subsequent accepting *undertakings*) other than to subsequent accepting *undertakings* which are in the same group; and**
 - (c) **for any subsequent cession or cessions of the ceded risk which are material (individually or in aggregate) each of the ceding and accepting *undertakings* (including subsequent accepting *undertakings*) is regulated by the FSA or a regulatory body in a *designated state or territory* for insurance (including *reinsurance*).**
- (3) **The change in value which a *firm* must determine for a contract of *reinsurance* or an analogous non-*reinsurance* financing agreement is the *firm's* best estimate of the change in realistic value which would result from changes in *credit risk* market conditions consistent, subject to (4), with the changes in credit spreads determined in accordance with PRU 7.4.75R(1).**
- (4) **For the purpose of (3), 5% should be replaced by 10% in PRU 7.4.81R(2)(b).**

- 7.4.92 G (1) Reinsurance and analogous non-reinsurance financing agreements entered into by the firm, either with or acting as a *reinsurer*, must be included within the scope of the scenario. The combined rights and obligations under a contract of *reinsurance* or an analogous non-*reinsurance* financing agreement may represent an economic asset or liability. The value placed by the *firm* on the *reinsurance* item or non-*reinsurance* financing item should allow for a realistic assessment of the risks transferred and the risks of counterparty default associated with the item. In the case of analogous non-*reinsurance* financing agreements, references to terms such as "*reinsurer*", "*ceding undertakings*" and "*accepting undertakings*" include *undertakings* which by analogy are *reinsurers*, ceding or accepting *undertakings*. Analogous non-*reinsurance* financing agreements include contingent loans, securitisations and any other arrangements giving rise to charges on future surplus arising.
- (2) In assessing values in accordance with PRU 7.4.91R, a *firm* may consider it appropriate to determine values by drawing analogy with the approach in respect of bond and debt items set out in PRU 7.4.81R. (This might be the case if, in economic terms, the item being valued sufficiently resembles a bond or debt item - an alternative approach might otherwise be preferred). If the *firm* does consider it appropriate to draw an analogy, the "credit spread" assumed should be consistent with the assumed default probabilities and the values placed on the *reinsurance* asset for the purposes of determining the *realistic values of assets and liabilities*. A *firm* may regard it as appropriate to have regard to any financial strength ratings applicable to the *reinsurer*, but if so should apply the same principles set out in PRU 7.4.89R for the nomination of financial strength ratings. Table PRU 7.4.94G provides guidance as to the allocation of spread factors which a *firm* may, by analogy, deem appropriate to apply. Appropriate allowance should be made for any change in the extent of the counterparty exposure under the assumed scenario.

PRU 7.4 With-profits insurance capital component

- (3) The changes in *credit risk* spreads determined for bond and debt items in accordance with *PRU 7.4.75R(1)* are required to result in a reduction in market value for some items of 5 per cent of their current value through the operation of *PRU 7.4.81R(2)(b)*. For *reinsurance* contracts and analogous non-*reinsurance* financing agreements, determining the change in value by reference to *PRU 7.4.91R(3)* requires a *firm* to consider the possibility of counterparty default in changed *credit risk* market conditions. Where in the changed *credit risk* market conditions assumed to apply the *firm's* assessment of the counterparty risk would result in the asset being considered equivalent to "Highly speculative or very vulnerable", the reduction in value required is at least 10% of its current value. *PRU 7.4.91R(4)* relates to this requirement.

7.4.93 G A financial strength rating of a *reinsurer* refers to a current assessment of the financial security characteristics of the *reinsurer* with respect to its ability to pay claims under its *reinsurance* contracts and treaties in accordance with their terms.

7.4.94 G Table: Listed rating agencies, financial strength descriptions and spread factors

Financial Strength Description	A.M. Best Company	FITCH IBCA	Moody's Investors Service	Standard & Poor's Corporation	Spread Factor
Superior, extremely strong	A++	AAA	Aaa	AAA	3.00
Superior, very strong	A+	AA	Aa	AA	5.25
Excellent or strong	A, A-	A	A	A	6.75
Good	B++,B+	BBB	Baa	BBB	9.25
Fair, marginal	B, B-	BB	Ba	BB	15.00
Marginal, weak	C++,C+	B	B	B	24.00
Unrated or very weak	Unrated or below C++,C+	Unrated or below B	Unrated or below B	Unrated or below B	24.00

CREDIT RISK SCENARIO FOR OTHER EXPOSURES (INCLUDING ANY DERIVATIVE OR QUASI-DERIVATIVE)

- 7.4.95 R** For the purposes of *PRU 7.4.75R(3)* the change in value which must be determined for any other item (including any *derivative* or *quasi-derivative*) which represents an economic asset under the single event applicable under *PRU 7.4.41R(3)* is the *firm's* best estimate of the change in the realistic value of that item which would result from changes in *credit risk* market conditions consistent with the changes in credit spreads determined in accordance with *PRU 7.4.75R(1)* and the changes in value determined in accordance with *PRU 7.4.75R(2)*.
- 7.4.96 G** In applying *PRU 7.4.95R* a *firm* should assess the total impact on the value of the item resulting from the assumed changed *credit risk* market conditions. The total change in value may result from the interaction of a number of separate influences. For example, a widening of credit spreads may imply an impact on the amount exposed to counterparty default as well as on the likelihood of that default. Each factor influencing the change in value needs separate consideration. It should be assumed, both for determining amounts exposed to counterparty default and the likelihood of such default that there will be no change in the likelihood of default in relation to an item issued by or guaranteed by an organisation which is in respect of that item a *credit risk* scenario exempt organisation. *PRU 7.4.94G(5)* is also relevant in this context.

PERSISTENCY RISK SCENARIO

- 7.4.97 R** For the purposes of the persistency risk scenario in *PRU 7.4.42R(6)*, a *firm* must allow for the effects of an increase or a decrease in persistency experience of its *with-profits insurance contracts* by adjusting the termination rates in each year of projection by 35% of the termination rates assumed in the calculation of the *realistic value of liabilities* in *PRU 7.4.38R*.
- 7.4.98 R** The termination rates referred to in *PRU 7.4.97R* are the rates of termination (including the paying-up of *policies*, but excluding deaths, maturities and retirements) other than on dates specified by the *firm* where:
- (1) a guaranteed amount applies as the minimum amount which will be paid on claim; or
 - (2) any payments to the *policyholder* cannot be reduced at the discretion of the *firm* by its applying a market value adjustment.
- 7.4.99 R** For the purposes of *PRU 7.4.97R*, the increase or decrease in termination rates must be applied to the projection of terminations up to *policy* guarantee dates and between *policy* guarantee dates, but not to the assumptions as to the proportion of *policyholders* taking up the guarantees at *policy* guarantee dates.

- 7.4.100 G *PRU 7.4.97R to PRU 7.4.99R require firms to apply a persistency stress test to the realistic value of liabilities. Where a firm brings the present value of non-profit insurance business in a with-profits fund into the calculation of the realistic value of assets (see PRU 7.4.32R) there is no requirement to stress this asset for changes in persistency assumptions.*

Realistic value of liabilities: detailed provisions

- 7.4.101 G *PRU 7.4.38R sets out the three elements comprising the realistic value of liabilities for a with-profits fund. The remainder of this section contains general rules and guidance on determining the realistic value of liabilities plus further detail relating to each of those elements separately, as follows:*
- (1) *general rules and guidance in PRU 7.4.102R to PRU 7.4.112G*
 - (2) *with-profits benefits reserve in PRU 7.4.113R to PRU 7.4.133G;*
 - (3) *future policy related liabilities in PRU 7.4.134R to PRU 7.4.187G; and*
 - (4) *realistic current liabilities in PRU 7.4.188R.*

METHODS AND ASSUMPTIONS: GENERAL

- 7.4.102 R **In calculating the realistic value of liabilities for a with-profits fund, a firm must use methods and assumptions which:**
- (1) are appropriate to the business of the firm;**
 - (2) are consistent from year to year without arbitrary changes (that is, changes without adequate reasons);**
 - (3) are consistent with the method of valuing assets (see PRU 1.3);**
 - (4) make full provision for tax payable out of the with-profits fund, based on current legislation and practice, together with any known future changes, and on a consistent basis with the other methods and assumptions used;**
 - (5) take into account discretionary benefits at least equal to, and charges no more than, the levels required for the firm to fulfil its regulatory duty to treat its customers fairly;**
 - (6) take into account management actions (see PRU 7.4.51R) and policyholder actions (see PRU 7.4.57R);**

- (7) provide for shareholder transfers out of the *with-profits fund* as a liability of the fund;
- (8) have regard to generally accepted actuarial best practice; and
- (9) are consistent with the *firm's PPFM*.

- 7.4.103 G More specific *rules* and *guidance* are set out below on some aspects of the methods and assumptions to be used in calculating the *realistic value of liabilities* for a *with-profits fund*. In contrast to the *mathematical reserves* requirements in PRU 7.3.11R(4) and PRU 7.3.14R, there is no requirement to include margins for adverse deviation of relevant factors in calculating the *realistic value of liabilities*. Assumptions need be no more prudent than is necessary to achieve a best estimate, taking into account the *firm's PPFM* and its regulatory duty to treat its *customers* fairly. Where there is no requirement for a *PPFM*, for example non-UK business, a *firm* should use assumptions that are consistent with the *firm's* documented approach to treating its *customers* fairly. A *firm* may judge that a margin should be included in its calculations to avoid an understatement of the *realistic value of liabilities* as a result of uncertainty, for example, either in its method or in its data.
- 7.4.104 G The amount and timing of tax charges affect the amount of assets available to meet *policyholder* liabilities. PRU 7.4.102R(4) requires *firms* to provide fully for all tax payable out of the *with-profits fund* on a basis consistent with the other assumptions and methods used in deriving the realistic balance sheet. So, for example, all projections which underlie the realistic valuation of assets or liabilities must allow for taxation. The approach adopted should not give any credit for any reduction in tax deriving from future expenses or deficits which is attributable to future new business. For assets backing capital requirements it is not necessary to take into consideration future tax charges on investment income generated by those assets. However, *firms* should consider this aspect in their capital planning.
- 7.4.105 G PRU 7.4.102R(7) requires *firms* to provide fully for shareholder transfers. Such transfers do not therefore count as capital in the *with-profits fund*. However, where a *firm* has put in place undertakings satisfactory to the FSA, including that future transfers will not be paid out of the *firm* by way of dividend, the FSA may be prepared to grant (under S148 of the Act) a *waiver* from the *rules* to enable such transfers to count as capital.

VALUATION OF CONTRACTS: GENERAL

- 7.4.106 R (1) A *firm* must determine the amount of the *with-profits benefits reserve* or the *future policy related liabilities* for a *with-profits fund* by carrying out a separate calculation in relation to each *with-profits insurance contract* or for each group of similar contracts.
- (2) Appropriate approximations or generalisations may be made where they are likely to provide the same, or a higher, result than a separate calculation for each contract.
- (3) A *firm* may set up additional reserves on an aggregated basis for general risks which are not specific to individual contracts or a group of similar contracts where the *firm* considers the *realistic value of liabilities* may otherwise be understated.

- 7.4.107 R For the purpose of PRU 7.4.106R(1), a group of similar contracts is such that the conditions in PRU 7.4.106R(2) are satisfied.**
- 7.4.108 G Where a *firm* has grouped individual contracts for the purpose of calculating the *mathematical reserves* for a *with-profits fund* (in accordance with PRU 7.3.23R), the *firm* is not required to use the same grouping of contracts in calculating the *with-profits benefits reserve* or *future policy related liabilities* for that fund.
- 7.4.109 G In contrast to PRU 7.3.25R for the *mathematical reserves*, treating individual contracts as an asset is not prohibited if, and to the extent that, this treatment does not conflict with a *firm's* regulatory duty to treat its *customers* fairly.
- 7.4.110 G In calculating the *with-profits benefits reserve*, an overall (grouped or pooled) approach may be appropriate under either of the two methods set out in PRU 7.4.113R. In particular, the calculation of aggregate retrospective reserves (see PRU 7.4.115R) and the projection of future cash flows (see PRU 7.4.126R) based on suitable specimen *policies* is permitted.
- 7.4.111 G In calculating the *future policy related liabilities*, the grouping of *policies* for valuing the costs of guarantees, options or smoothing, and their representation by representative *policies*, is acceptable provided the *firm* can demonstrate that the grouping of *policies* does not materially misrepresent the underlying exposure and does not significantly misstate the costs. A *firm* should exercise care in grouping *policies* in order to ensure that the risk exposure is not inappropriately distorted, by for example forming groups containing *policies* with guarantees that are “in the money” and *policies* with guarantees well “out of the money”. A *firm* should also have regard to the effects of *policyholder* behaviour over time on the spread of the outstanding guarantees or options.
- 7.4.112 G Where a *firm* groups similar *policies* for the purpose of calculating the *with-profits benefits reserve* or the *future policy related liabilities*, the *firm* should carry out sufficient validation to be reasonably sure that the grouping of *policies* has not resulted in the loss of any significant attributes of the portfolio being valued.

WITH-PROFITS BENEFITS RESERVE

- 7.4.113 R A *firm* must calculate a *with-profits benefits reserve* for a *with-profits fund* using either:**
- (1) a retrospective calculation under PRU 7.4.115R (the retrospective method); or
 - (2) a prospective calculation under PRU 7.4.126R of all future cash flows expected to arise under, or in respect of, each of the *with-profits insurance contracts* written in that fund (the prospective method).
- 7.4.114 R Subject to PRU 7.4.102R(2), a *firm* may use different methods under PRU 7.4.113R for different types or generations of *with-profits insurance contracts*.**

RETROSPECTIVE METHOD

- 7.4.115 R** In the retrospective method of calculating a *with-profits benefits reserve*, a *firm* must calculate either the aggregate of the retrospective reserves in respect of each *with-profits insurance contract* or, to the extent permitted by *PRU 7.4.106R* and *PRU 7.4.107R*, the total retrospective reserve in respect of each group of *with-profits insurance contracts*.
- 7.4.116 R** In calculating the retrospective reserve for a *with-profits insurance contract*, or the total retrospective reserve in respect of a group of *with-profits insurance contracts*, a *firm* must take account of at least the following:
- (1)** *premiums* received from the *policyholder*;
 - (2)** any expenses incurred or charges made (including *commissions*);
 - (3)** any partial benefits paid or due;
 - (4)** any investment income on, and any increases (or decreases) in, asset values;
 - (5)** any tax paid or payable;
 - (6)** any amounts received (or paid) under contracts of *reinsurance* or analogous non-*reinsurance* financing agreements, where relevant to retrospective reserves;
 - (7)** any shareholder transfers and any associated tax paid or payable; and
 - (8)** any permanent enhancements to (or deductions from) the retrospective reserves made by the *firm*.
- 7.4.117 G** In taking account of amounts in *PRU 7.4.116R(6)*, due regard should be had to the specific details of each relevant contract of *reinsurance* or analogous non-*reinsurance* financing agreement and the relationship between the amounts received (or paid) and the value of the benefit granted (or received) under the arrangement. This should take into consideration, for example, the risk of default and differences in the *firm's* realistic assessment of the risks transferred and the contractual terms for such transfer of risk. Analogous non-*reinsurance* financing agreements include contingent loans, securitisations and any other arrangements giving rise to charges on future surplus arising.
- 7.4.118 G** Where allowance is made for shareholder transfers, this should be in respect of the accrued bonus entitlement reflected in the retrospective reserve. This would include both *annual* bonuses already declared and accrued *final bonus*. However, shareholder transfers in respect of surplus yet to be credited to retrospective reserves should not be charged to those reserves until the corresponding surplus is credited.

- 7.4.119 R In calculating retrospective reserves, a *firm* must have regard to its regulatory duty to treat its *customers* fairly and must ensure that its approach is consistent with its *Principles and Practices of Financial Management*.**
- 7.4.120 G A *firm* should make sure that its calculation of retrospective reserves is consistent with any representations made to *policyholders*. In particular, any charges made to retrospective reserves for the cost of guarantees or options should be in accordance with the *firm's* *PPFM* and with its regulatory duty to treat its *customers* fairly.
- 7.4.121 R In calculating retrospective reserves, a *firm* must ensure its treatment of past cash flows, and of any future cash flows, is consistent with those cash flows valued in its prospective calculation of the *future policy related liabilities* for that fund in accordance with the *rules and guidance* in *PRU 7.4.134G* to *PRU 7.4.187G*.**
- 7.4.122 G An example of *PRU 7.4.121R* concerns future shareholder transfers. A *firm* must make adequate provision for future shareholder transfers within the *future policy related liabilities* (see *PRU 7.4.158R*). The basis of provisioning needs to be consistent with the amounts accrued within retrospective reserves and the amounts already transferred out of the *with-profit fund*.
- 7.4.123 G Another example of *PRU 7.4.121R* relates to the reference in *PRU 7.4.116R*(8) to past permanent enhancements to (or deductions from) retrospective reserves made by *firms*. This item may include past miscellaneous surplus (or losses) which have been credited to (or debited from) retrospective reserves. Any other enhancements (or deductions) made on a temporary basis and any future surplus (or losses) that *firms* intend to credit to (or debit from) retrospective reserves should be included under the *future policy related liabilities* (see *PRU 7.4.135R*).
- 7.4.124 G *Firms* characteristically use a range of calculation methods to determine retrospective reserves. A *firm's* definition and calculation of retrospective reserves will depend on a number of factors. These include: the *firm's* practice; its administration and accounting systems; the extent of its historical records; and the composition of its with-profits portfolio. The *rules and guidance* for the retrospective method are drawn up to be sufficiently flexible to accommodate the diversity of calculation methods used by *firms*, rather than to enforce any particular method of calculation of retrospective reserves. *PRU 7.4.116R* simply sets minimum standards that all retrospective methods must meet.
- 7.4.125 G For the purposes of *PRU 7.4.116R*(2) and *PRU 7.4.126R*(2), the phrases 'charges made' or 'charges to be made' refer to circumstances where types of risk (such as mortality risk, longevity risk and investment risk) are met by the *firm* or *with-profits fund* in return for a charge deducted by the *firm* from the *with-profits benefits reserve*.

PROSPECTIVE METHOD

- 7.4.126 R In the prospective method of calculating a *with-profits benefits reserve*, a *firm* must take account of at least the following cash flows:**
- (1) **future *premiums*;**

- (2) expenses to be incurred or charges to be made, including *commissions*;
- (3) benefits payable (see *PRU 7.4.127R*);
- (4) tax payable;
- (5) any amounts to be received (or paid) under contracts of *reinsurance* or analogous non-*reinsurance* financing agreements, where relevant to *with-profits insurance contracts* being valued; and
- (6) shareholder transfers.

7.4.127 R For the purposes of *PRU 7.4.126R*(3), benefits payable include:

- (1) all guaranteed benefits, including guaranteed amounts payable on death and maturity, guaranteed *surrender values* and paid-up values;
- (2) vested, declared and allotted bonuses to which *policyholders* are entitled; and
- (3) future *annual* and *final bonuses* at least equal to the levels required for the *firm* to fulfil its regulatory duty to treat its *customers* fairly.

7.4.128 R A *firm* must value the cash flows listed in *PRU 7.4.126R* using best estimate assumptions of future experience, having regard to generally accepted actuarial best practice and taking into account the *firm's PPFM* and its regulatory duty to treat its *customers* fairly.

7.4.129 G The prospective method sets the *with-profits benefits reserve* at the net present value of future cash flows listed in *PRU 7.4.126R*.

7.4.130 G In contrast to *PRU 7.3.11R*(4) and *PRU 7.3.14R* relating to the methods and assumptions used to value the *mathematical reserves*, there is no requirement to value future cash flows using assumptions that include margins for adverse deviation. Also there are no detailed *rules* as to the future yields on assets, discount rates, *premium* levels, expenses, tax, mortality, morbidity, persistency and *reinsurance*. A *firm* should make its own assessment as to the amount of these future cash flows including bonuses and discretionary surrender or transfer values. A *firm* should make a realistic assessment of longevity risk and asset default risk (including default risk arising under contracts of *reinsurance* or analogous non-*reinsurance* financing agreements) within the best estimate assumptions of future experience required by *PRU 7.4.128R*.

7.4.131 G In valuing the future cash flows listed in *PRU 7.4.126R*, the *firm* should use a projection term which is long enough to capture all material cash flows arising from the contract or groups of contracts being valued. If the projection term does not extend to the term of the last *policy*, the *firm* should check that the shorter projection term does not significantly affect the results.

- 7.4.132 R** Where a *firm* expects to pay additional benefits that are not included in the cash flows listed in *PRU 7.4.126R*, it must make adequate provision for these benefits in calculating the *future policy related liabilities* in accordance with the *rules and guidance* in *PRU 7.4.134G* to *PRU 7.4.187G*.
- 7.4.133 G** The prospective assessment of the *with-profits benefits reserve* will usually be on a deterministic basis. A *firm* will have to make further provision in the *future policy-related liabilities* for, for example, the costs of potential asset fluctuations or *policy options*.

FUTURE POLICY RELATED LIABILITIES

OVERVIEW OF LIABILITIES

- 7.4.134 G** *PRU 7.4.135R* lists the *future policy related liabilities* for a *with-profits fund* that form part of a *firm's realistic value of liabilities* in *PRU 7.4.38R*. Detailed *rules and guidance* relating to particular types of liability and asset are set out in *PRU 7.4.137R* to *PRU 7.4.164G*. These are followed by *rules and guidance* that deal with certain aspects of several liabilities (that is, liabilities relating to guarantees, options and smoothing):
- (1) *PRU 7.4.167R* to *PRU 7.4.184G* refer to valuing the costs of guarantees, options and smoothing; and
 - (2) *PRU 7.4.185R* to *PRU 7.4.187G* refer to the treatment of surplus on guarantees, options and smoothing.
- 7.4.135 R** The *future policy related liabilities* for a *with-profits fund* are equal to the sum of amounts, as they relate to that fund, in respect of (1) to (11) to the extent each is valued as a liability less the sum of amounts, as they relate to that fund, in respect of (1) to (11) to the extent each is valued as an asset:
- (1) past miscellaneous surplus (or deficit) planned to be attributed to the *with-profits benefits reserve* (see *PRU 7.4.137R*);
 - (2) planned enhancements to the *with-profits benefits reserve* (see *PRU 7.4.139R*);
 - (3) planned deductions for the costs of guarantees, options and smoothing from the *with-profits benefits reserve* (see *PRU 7.4.142R*);
 - (4) planned deductions for other costs deemed chargeable to the *with-profits benefits reserve* (see *PRU 7.4.144R*);
 - (5) future costs of contractual guarantees (other than financial options) (see *PRU 7.4.146R*);
 - (6) future costs of non-contractual commitments (see *PRU 7.4.152R*);

- (7) future costs of financial options (see *PRU 7.4.154G*);
- (8) future costs of smoothing (see *PRU 7.4.156R*);
- (9) financing costs (see *PRU 7.4.160R*);
- (10) any other further liabilities required for the *firm* to fulfil its regulatory duty to treat its *customers* fairly; and
- (11) other *long-term insurance liabilities* (see *PRU 7.4.163R*).

7.4.136 G Some of the elements of the calculation set out in *PRU 7.4.135R* may have already been taken into consideration in the calculation of the *with-profits benefits reserve*, either under the retrospective method (see *PRU 7.4.115R* onwards) or the prospective method (see *PRU 7.4.126R* onwards). Where this is the case the adjustments made under *PRU 7.4.135R* should be such that no double-counting arises.

PAST MISCELLANEOUS SURPLUS (OR DEFICIT) PLANNED TO BE ATTRIBUTED TO THE WITH-PROFITS BENEFITS RESERVE

7.4.137 R In calculating the *future policy related liabilities* for a *with-profits fund*, a *firm* must allow for past miscellaneous surplus (or deficit) which it intends to attribute to the *with-profits benefits reserve* for that fund but which has not yet been permanently credited to (or debited from) the *with-profits benefits reserve* for that fund.

7.4.138 G Past miscellaneous surplus (or deficit) already permanently credited to (or debited from) the *with-profits benefits reserve* will have been included in the calculation of the *with-profits benefits reserve* in accordance with *PRU 7.4.116R*(8).

PLANNED ENHANCEMENTS TO THE WITH-PROFITS BENEFITS RESERVE

7.4.139 R In calculating the *future policy related liabilities* for a *with-profits fund*, a *firm* must make provision for any future planned enhancements to the *with-profits benefits reserve* for that fund that cannot be financed out of the resources of the *with-profits benefits reserve* and future *premiums*.

7.4.140 G For the purposes of *PRU 7.4.139R*, planned enhancements to the *with-profits benefits reserve* will arise when a *firm* has a contractual obligation, or a non-contractual intention, to enhance *claims* on some classes of *policy* (perhaps in the form of specially enhanced future bonus rates). In such circumstances, the present value of the costs of paying out a target *asset share* that is more than the projected *with-profits benefit reserve* for those classes of *policy* for which this practice is applicable should be included in the amount of the *future policy related liabilities*. For example, a *firm* may intend to pay enhanced benefits but have discretion not to make such payments in adverse circumstances. Such planned enhancements should be provided for in the realistic balance sheet, but allowance should be made for management action in the calculation of the *risk capital margin*.

PRU 7.4 With-profits insurance capital component

- 7.4.141 G The valuation of *claims* in excess of targeted *asset shares* in respect of guarantees, options and smoothing, including those arising under guaranteed annuity rates, should be carried out in accordance with *PRU 7.4.167R* to *PRU 7.4.184G*.

PLANNED DEDUCTIONS FOR THE COSTS OF GUARANTEES, OPTIONS AND SMOOTHING FROM THE WITH-PROFITS BENEFITS RESERVE

- 7.4.142 R Where a *firm* expects to deduct future charges from the *with-profits benefits reserve* for a *with-profits fund* to cover the costs of guarantees, options or smoothing for that fund, the *firm* must take credit for these future charges in calculating the *future policy related liabilities* for that fund.

- 7.4.143 G In calculating *future policy related liabilities* for a *with-profits fund*, a *firm* should take credit under *PRU 7.4.135(3)R* for the present value of the future “margins” available in respect of charges deducted to cover the costs of guarantees, options and smoothing. *PRU 7.4.179R* requires *firms* that accumulate the charges made less costs incurred to provide for any surplus on the experience account as a realistic liability. Any such provision should be made under *PRU 7.4.135R* (5), (7) or (8), depending on the nature of the charges made, and has no effect on the amount calculated under *PRU 7.4.142R*.

PLANNED DEDUCTIONS FOR OTHER COSTS DEEMED CHARGEABLE TO THE WITH-PROFITS BENEFITS RESERVE

- 7.4.144 R Where a *firm* expects to deduct future charges (other than those valued in *PRU 7.4.142R*) from the *with-profits benefits reserve* for a *with-profits fund*, the *firm* must take credit for these future charges in calculating the *future policy related liabilities* for that fund.

- 7.4.145 G A *firm* should take credit for the present value of the other future “margins” available. The circumstances where such margins may arise include:
- (1) where a *firm* is targeting *claims* at less than 100% of the *with-profits benefits reserve*, the amount of such shortfall; and
 - (2) where a *firm* expects to deduct any future charges (other than those for guarantees, options and smoothing) from the *with-profits benefits reserve*.

FUTURE COSTS OF CONTRACTUAL GUARANTEES (OTHER THAN FINANCIAL OPTIONS)

- 7.4.146 R A *firm* must make provision for the costs of paying excess *claim* amounts for a *with-profits fund* where the *firm* expects that the amount in (1) may be greater than the amount in (2), calculated as at the date of *claim*:
- (1) the value of guarantees arising under a *policy* or group of *policies* in the fund; and

(2) the fund's *with-profits benefits reserve* allocated in respect of that *policy* or group of *policies*.

- 7.4.147 R For the purposes of PRU 7.4.146R, the future costs of guarantees cannot be negative.**
- 7.4.148 G In carrying out projections to calculate the cost of guarantees under PRU 7.4.135R the opening liability should be set equal to the *with-profits benefit reserve* (see PRU 7.4.115R), adjusted for miscellaneous surplus or deficits (see PRU 7.4.135R(1)) and planned enhancements (see PRU 7.4.139R).
- 7.4.149 G In projecting forward the *with-profits benefits reserve*, adjusted as in PRU 7.4.148G, to the date of *claim* for the purposes of PRU 7.4.146R, the *firm* should use best estimates of the expected future *premium* and investment income (including realised and unrealised gains or losses), expenses and *claims*, any charges to be deducted, tax and any other item of income or outgo. This projection should be carried out on the same basis as is required in PRU 7.4.128R.
- 7.4.150 G PRU 7.4.167R to PRU 7.4.183G contain further *rules* and *guidance* on the valuation of guarantees, options and smoothing.
- 7.4.151 G Some examples of contractual guarantees are:
- (1) for conventional *with-profits insurance contracts*, guaranteed sums assured and bonuses on death, maturity or retirement; and
 - (2) for *accumulating with-profits policies*, guarantees at a point in time or guaranteed minimum bonus rates.

FUTURE COSTS OF NON-CONTRACTUAL COMMITMENTS

- 7.4.152 R A *firm* must make provision for future costs in addition to those in PRU 7.4.146R where the *firm* expects to pay further amounts to meet non-contractual commitments to *customers* or pay other benefits that need to be provided to fulfil a *firm's* regulatory duty to treat its *customers* fairly.**
- 7.4.153 G Some examples of these non-contractual commitments are:
- (1) statements by the *firm* regarding the ability of *policies* to cover defined amounts, such as the repayment of a mortgage;
 - (2) statements by the *firm* regarding regular withdrawals from a *policy* being without penalty;
 - (3) guaranteed annuity and cash option rates being provided beyond the strict interpretation of the *policy*; and
 - (4) the costs of any promises to *customers* or other benefits that need to be provided to fulfil a *firm's* regulatory duty to treat its *customers* fairly.

FUTURE COSTS OF FINANCIAL OPTIONS

- 7.4.154 G Financial options include guaranteed annuity and cash option rates.
- 7.4.155 G *PRU 7.4.167R to PRU 7.4.183G contain further rules and guidance on the valuation of options.*

FUTURE COSTS OF SMOOTHING

- 7.4.156 R A firm must make provision for future smoothing costs of a *with-profits fund* where the *firm* expects that the *claims* paid on a *policy* or group of *policies* in the fund will vary from the greater of:**
- (1) the value of guarantees determined in *PRU 7.4.146R* in respect of that *policy* or group of *policies*; and**
 - (2) the fund's *with-profits benefits reserve* allocated in respect of that *policy* or group of *policies*, which must be enhanced as described in *PRU 7.4.139R*;**
- calculated as at the date of *claim*.**
- 7.4.157 R For the purposes of *PRU 7.4.156R*, smoothing costs are defined as the present value of the difference between projected *claims* and the projected *with-profits benefit reserve* after enhancements (see *PRU 7.4.139R*), other than payouts on guarantees (see *PRU 7.4.146R*).**
- 7.4.158 R Subject to *PRU 7.4.186R*, the future costs of smoothing can be negative.**
- 7.4.159 G *PRU 7.4.167R to PRU 7.4.184G contain further rules and guidance on the valuation of the future costs of smoothing.*

FINANCING COSTS

- 7.4.160 R A firm must provide for future liabilities to repay financing costs of a *with-profits fund* where the *firm* expects to have to meet such liabilities and to the extent that these liabilities are not already provided for by amounts included in the fund's *realistic current liabilities* (see *PRU 7.4.188R*). The amount of the liabilities to repay financing costs must be assessed on a market-consistent basis.**
- 7.4.161 G In *PRU 7.4.160R*, financing costs refer to the future costs incurred by way of capital, interest and fees payable to the provider. A *firm* should make a realistic assessment of the requirement to repay such financing in its expected future circumstances (which may be worse than currently). Having taken account of its particular circumstances:

PRU 7.4 With-profits insurance capital component

- (1) where a *firm* has no liability to repay such financing, it should not include such repayment as a liability;
- (2) where a *firm* has a reduced liability to repay such financing, it should include a reduced repayment as a liability.

7.4.162 G In *PRU 7.4.160R*, financing includes *reinsurance* financing arrangements and analogous non-*reinsurance* financing arrangements, such as contingent loans, securitisations and any other arrangements giving rise to charges on future surplus arising.

OTHER LONG-TERM INSURANCE LIABILITIES

7.4.163 R A *firm* must provide for any other *long-term insurance liabilities* arising from or in connection with *with-profits insurance contracts* in a *with-profits fund*, to the extent that adequate provision has not been made in the *with-profits benefits reserve* or in any other part of the *future policy related liabilities* for that fund.

7.4.164 G Some examples of these other *long-term insurance liabilities* are:

- (1) pension and mis-selling reserves;
- (2) provisions for tax; and
- (3) provisions for future shareholder transfers.

7.4.165 G In determining the realistic liability for taxation *firms* should apply the general principles set out in *PRU 7.4.102R* and the guidance given in *PRU 7.4.104G*.

7.4.166 G *PRU 7.4.102R* requires *firms* to provide for shareholder transfers out of the *with-profits fund* as a liability of the fund. The provision should be consistent with the methods and assumptions used in valuing the other realistic liabilities. So, for example, where the *with-profits benefits reserve* includes amounts that would be paid to *policyholders* through future bonuses, provision should also be made for future shareholder transfers associated with those bonuses.

VALUING THE COSTS OF GUARANTEES, OPTIONS AND SMOOTHING

7.4.167 R For the purposes of *PRU 7.4.135R*(5), (7) and (8), a *firm* must calculate the costs of any guarantees, options and smoothing using one or more of the following three methods:

- (1) a stochastic approach using a market-consistent asset model (see *PRU 7.4.168R*);
- (2) using the market costs of hedging the guarantee or option; or
- (3) a series of deterministic projections with attributed probabilities.

7.4.168 R The market-consistent asset model in *PRU 7.4.167R*(1):

- (1) means a model that delivers prices for assets and liabilities that can be directly verified from the market; and**
- (2) must be calibrated to deliver market-consistent prices for those assets that reflect the nature and term of the *with-profits insurance liabilities of the with-profits fund*.**

- 7.4.169 G Deterministic approaches will not usually capture the time value of the option generated by a guarantee. In order to calculate this value properly, *firms* are expected either to use market option values where these are readily available or to undertake a stochastic approach using a market-consistent asset model.
- 7.4.170 G The *FSA* considers stochastic modelling to be preferable for material groups or classes of *with-profits insurance contracts* unless it can be shown that more simplistic or alternative methods are both appropriate and sufficiently robust.
- 7.4.171 G Where the guarantee or option is relatively simple in nature, is capable of being hedged, and has a value unlikely to be affected by management actions (see *PRU 7.4.183R*) (for example, a guaranteed annuity rate option) then the cost of the guarantee or option would be the market cost of hedging the guarantee. Where that is generally the case but, in respect of a minor part of a portfolio, no market exists for hedging the option generated by the guarantee, a *firm* should take the value of the nearest equivalent benefit or right for which a market exists and record how it has adjusted the valuation to reflect the original option. Where the market value of the hedge is used *firms* should also make provisions for the *credit risk* arising from the hedge, both that arising from exposure to a counterparty and that arising from *credit risk* in the underlying instrument. The extent to which the guarantee or option is capable of being hedged depends on a *firm's* assumptions regarding future investment mix, persistency, annuitant mortality and take-up rates. While the *FSA* recognises that the hedge may not be perfectly matched to the underlying guarantee or option, a *firm* should ensure that hedge is reasonably well matched having regard to the sensitivity of the guarantee or option to the *firm's* choice of key assumptions.
- 7.4.172 G Where a *firm* has large cohorts of guarantees and uses stochastic or deterministic approaches, a *firm* should have regard to whether the cost of the guarantees determined under those approaches bears a reasonable relationship to the market cost of hedging those guarantees (where it exists).
- 7.4.173 G In determining the costs of smoothing, a *firm* should consider:
- (1) the consistency of its assumptions (including the exercise of management discretion over bonus rates); and
 - (2) where targeted payouts currently exceed retrospective reserves in respect of those claims, the assumptions used in reducing the excess, if applicable,
- having regard to the *firm's PPFM* and its regulatory duty to treat its *customers* fairly.

PRU 7.4 With-profits insurance capital component

STOCHASTIC APPROACH

- 7.4.174 G For the purposes of *PRU 7.4.167R(1)*, a stochastic approach would consist of an appropriate market-consistent asset model for projections of asset prices and yields (such as equity prices, fixed interest yields and property yields), together with a dynamic model incorporating the corresponding value of liabilities and the impact of any foreseeable actions to be taken by management. Under the stochastic approach, the cost of the guarantee, option or smoothing would be equal to the average of these stochastic projections.
- 7.4.175 G In performing the projections of assets and liabilities under the stochastic approach in *PRU 7.4.167R(1)*, a *firm* should have regard to the aspects in (1) and (2):
- (1) The projection term should be long enough to capture all material cash flows arising from the contract or groups of contracts being valued. If the projection term does not extend to the term of the last *policy*, the *firm* should check that the shorter projection term does not significantly affect the results.
 - (2) The number of projections should be sufficient to ensure a reasonable degree of convergence in the results, including the determination of the result of the *risk capital margin*. The *firm* should test the sensitivity of the results to the number of projections.
- 7.4.176 G The *FSA* considers a holistic approach to stochastic modelling to be preferable so as to value all items of costs together rather than using separate methods for different items of the *realistic value of liabilities*. This approach requires the projection of all material cash flows arising under the contract or group of contracts for each stochastic projection, rather than only those arising from the guarantee or option within the contract. The advantages of this approach are that it ensures greater consistency in the valuation of different components of the contract and explicitly takes into account the underlying hedges or risk mitigation between components of the contract or group of contracts being valued. Where a *firm* can use a stochastic approach to value simultaneously all components of the contract or group of contracts, the *firm* should adopt this approach where practical and feasible.
- 7.4.177 G Where a stochastic approach is used, a *firm* should make and retain a record under *PRU 7.4.16R* of the nature of the asset model and of the assumptions used (including the volatility of asset values and any assumed correlations between asset classes or between asset classes and economic indicators, such as inflation).
- 7.4.178 G In calibrating asset models for the purposes of *PRU 7.4.168R*, a *firm* should have regard to the aspects in (1), (2) and (3):
- (1) Few (if any) asset models can replicate all the observable *market values* for a wide range of asset classes. A *firm* should calibrate its asset models to reflect the nature and term of the fund's liabilities giving rise to significant guarantee and option costs.
 - (2) A *firm* will need to apply judgement to determine suitable estimates of those parameters which cannot be implied from observable market prices (for example, long-term volatility). A *firm* should make and retain a record under *PRU 7.4.16R* of the choice of parameters and the reasons for their use.
 - (3) A *firm* should calibrate the model to the current risk-free yield curve. Risk-free yields should be determined after allowing for credit and all other risks arising. *Firms* may have regard to any guidance from the actuarial profession on the calculation of the risk-free yield but should not assume a higher yield than suggested by any such guidance.

DETERMINISTIC APPROACH

- 7.4.179 R For the purposes of the deterministic approach in *PRU 7.4.167R(3)*, a *firm* must calculate a series of deterministic projections of the values of assets and corresponding liabilities, where each deterministic projection corresponds to a possible economic scenario or outcome.**
- 7.4.180 G** A *firm* should determine a range of scenarios or outcomes appropriate to both valuing the costs of the guarantee, option or smoothing and the underlying asset mix, together with the associated probability of occurrence. These probabilities of occurrence should be weighted towards adverse scenarios to reflect market pricing for risk. The costs of the guarantee, option or smoothing should be equal to the expected cost based on a series of deterministic projections of the values of assets and corresponding liabilities. In using a series of deterministic projections, a *firm* should consider whether its approach provides a suitably robust estimate of the costs of the guarantee, option or smoothing.
- 7.4.181 G** In performing the projections of assets and liabilities under the deterministic approach in *PRU 7.4.167R(3)*, a *firm* should have regard to the aspects in (1) and (2):
- (1) The projection term should be long enough to capture all material cash flows arising from the contract or group of contracts being valued. If the projection term does not extend to the term of the last *contract*, the *firm* should check that the shorter projection term does not significantly affect the results.
 - (2) The series of deterministic projections should be numerous enough to capture a wide range of possible outcomes and take into account the probability of each outcome's likelihood. The costs will be understated if only relatively benign or limited economic scenarios are considered.
- 7.4.182 G** Where a series of deterministic projections is used, a *firm* should make and retain a record under *PRU 7.4.16R* of the range of projections and how the probabilities attributed to each projection or outcome were determined (including the period of reference for any relevant data on past experience).

MANAGEMENT AND POLICYHOLDER ACTIONS

- 7.4.183 R In calculating the costs of any guarantees, options or smoothing, a *firm*:**
- (1) may reflect its management actions (within the meaning of *PRU 7.4.51R*); and**
 - (2) must reflect a realistic assessment of the *policyholder* actions (within the meaning of *PRU 7.4.57R*);**
- in its projections of the value of assets and liabilities.**
- 7.4.184 G** For the purposes of *PRU 7.4.183R*, the related guidance in *PRU 7.4.52G* to *PRU 7.4.54G* (management actions) and in *PRU 7.4.58G* (*policyholder* actions) applies.

TREATMENT OF SURPLUS ON GUARANTEES, OPTIONS AND SMOOTHING

- 7.4.185 R** *PRU 7.4.186R* applies to *firms* calculating the costs of guarantees, options and smoothing to be included in the *future policy-related liabilities* in accordance with *PRU 7.4.135R(5)*, (7) and (8).
- 7.4.186 R** Where a *firm* accumulates past experience and deducts or is otherwise able to take credit for charges for guarantees or options or smoothing, the future costs of guarantees or options or smoothing (as appropriate) must not be less than the greater of:
- (1) the prospective calculation of the future cost of guarantees (see *PRU 7.4.146R*) or options (see *PRU 7.4.154G*) or smoothing (see *PRU 7.4.156R*) (as appropriate); and
 - (2) the sum of:
 - (a) the accumulated charges (after deduction of past costs) for guarantees or options or smoothing (as appropriate); and
 - (b) the prospective calculation of the future charges deducted for guarantees or options or smoothing (see *PRU 7.4.142R*) (as appropriate).
- 7.4.187 G** The extent to which the amount in *PRU 7.4.186R(2)* exceeds the amount in *PRU 7.4.186R(1)* will determine the surplus available to support actions that would be taken by the *firm's* management. The purpose of *PRU 7.4.186R* is to ensure that any resulting surplus at the valuation date arising from the accumulation of charges less costs remains available to support foreseeable actions that would be taken by the *firm's* management. Any additional liability arising from *PRU 7.4.188R* is added to the liabilities under *PRU 7.4.135(5)*, (7) and (8) but has no impact on the adjustment for planned deductions for the costs of guarantees, options and smoothing (see *PRU 7.4.135R(3)* and *PRU 7.4.142R*).

REALISTIC CURRENT LIABILITIES

- 7.4.188 R** For the purposes of *PRU 7.4.38R(3)*, the *realistic current liabilities* of a *with-profits fund* are equal to the sum of the following amounts:
- (1) the *firm's* best estimate provision for those liabilities for which prudent provision is made in *regulatory current liabilities* (see *PRU 7.4.29R*); and
 - (2) to the extent that amounts have not been provided in (1), any tax and any other costs arising either in respect of excess *admissible assets* (within the meaning of *PRU 7.4.35R*) or on the recognition of future shareholder transfers.

7.5 Equalisation provisions

Application

- 7.5.1 R This section applies to *insurers*, referred to as *firms* in this section.
- 7.5.2 R This section does not apply to a *firm* which is:
- (1) a *non-directive friendly society*;
 - (2) an *incoming EEA firm*;
 - (3) an *incoming Treaty firm*.
- 7.5.3 G The scope of PRU 7.5.12R to PRU 7.5.38G (*non-credit equalisation provisions*) is not restricted to *firms* subject to the relevant EC directives. It applies, for example, to *pure reinsurers*.
- 7.5.4 G The requirements of this section apply to a *firm* on a solo basis.

Purpose

- 7.5.5 G This section sets out *rules* and *guidance* on the calculation of the amount of the *equalisation provisions* that are required to be maintained by *firms* that carry on non-credit *insurance business* or credit *insurance business*.
- 7.5.6 G *Credit* or *non-credit equalisation provisions* form part of the *technical provisions* that a *firm* is required to establish under PRU 7.2.13R (1). They help to smooth fluctuations in loss ratios in future years for business where *claims* in any future year may be subject to significant deviation from recent or average *claims* experience, or where trends in experience may be subject to change. Such volatile *claims* experience might arise in the case, for example, of insurance against losses caused by major catastrophes such as hurricanes or earthquakes.
- 7.5.7 G In general terms, PRU 7.5 sets out *rules* and *guidance* as to:
- (a) the circumstances in which a *firm* is required to maintain *equalisation provisions*;
 - (b) the methods to be used in calculating the amount of each provision;
 - (c) the geographical location of the business relevant to certain calculations for different types of *firm* – this is summarised in the Table in PRU 7.5.8G.

7.5.8

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Table : Scope of <i>insurance business</i> to be included in calculations				
TYPE OF FIRM		CREDIT EQUALISATION PROVISION		NON CREDIT EQUALISATION PROVISION
		Threshold in <i>PRU</i> 7.5.45R	Provision in <i>PRU</i> 7.5.44R	Threshold in <i>PRU</i> 7.5.19R(2) and provision in <i>PRU</i> 7.5.18R
<i>UK insurer</i>		World-wide	World-wide	World-wide
<i>Pure reinsurer with Head Office outside United Kingdom</i>		<i>PRU</i> 7.5.39R to <i>PRU</i> 7.5.48G do not apply		UK
<i>Pure reinsurer with Head Office in United Kingdom</i>		<i>PRU</i> 7.5.39R to <i>PRU</i> 7.5.48G do not apply		World-wide
<i>Non EEA direct insurers</i>	<i>EEA-deposit insurer</i>	UK	UK	UK
	<i>Swiss general insurer</i>	UK	UK	UK
	<i>UK-deposit insurer</i>	All EEA	World-wide	UK
	<i>All other non EEA direct insurers*</i>	UK	World-wide	UK

7.5.9

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The *First Non-Life Directive* (as amended) requires the calculation of *credit equalisation provisions*. *Non-credit equalisation provisions* are a domestic *United Kingdom* requirement. For insurance regulatory purposes under EC Directives, *credit equalisation provisions* are classified as liabilities.

7.5.10

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However, *firms* are permitted to include *equalisation provisions* within their financial resources when demonstrating compliance with non-Directive capital requirements. Hence *equalisation provisions* are deducted from the available capital resources of a *firm* for the purpose of meeting its *minimum capital requirement* for *general insurance business*; but, in the calculation of a *firm's enhanced capital requirement* for *general insurance business* under *PRU* 2.3.11R, its *equalisation provisions* (if any) are added back to its capital resources.

7.5.11

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Under International Accounting Standards (IAS), likely to apply to the financial statements of *insurers* from 2005, it is likely that there will be no requirement to treat *equalisation provisions* as liabilities in *insurers'* published financial statements. However, they will continue to be treated as liabilities for the purposes of demonstrating compliance with

Directive capital requirements.

Non-credit equalisation provision

FIRMS CARRYING ON NON-CREDIT EQUALISATION BUSINESS

- 7.5.12 R (1)** *PRU 7.5.12R to PRU 7.5.38G apply to any firm, other than an assessable mutual, which carries on the business of effecting or carrying out general insurance contracts falling within any description in column 2 in Table PRU 7.5.13R ("non-credit insurance business").*
- (2)** *A firm falling within (1) must classify all of its non-credit insurance business into separate insurance business groupings, as specified in Table PRU 7.5.13R.*

7.5.13 R Table : Groupings of non-credit equalisation *insurance business*

<u>INSURANCE BUSINESS GROUPING</u>	<u>GENERAL INSURANCE CONTRACTS</u>
A	Contracts of insurance which fall within general insurance business classes 4, 8 or 9, other than: (a) contracts of insurance under non-proportional reinsurance treaties; and (b) contracts of insurance against nuclear risks.
B	Contracts of insurance which fall within general insurance business class 16(a) , other than: (a) contracts of insurance under non-proportional reinsurance treaties, and (b) contracts of insurance against nuclear risks.
C	Contracts of insurance which fall within general insurance business classes 5, 6, 11 or 12, other than: (a) contracts of insurance against nuclear risks; and (b) reinsurance contracts corresponding to contracts in (a).
D	Contracts of insurance against nuclear risks.
E	Contracts of insurance under non-proportional reinsurance treaties and which fall within general insurance business classes 4, 8, 9 or 16a other than contracts of insurance against nuclear risks.

- 7.5.14 R** For the purposes of *PRU 7.5.12R to PRU 7.5.38G*, a firm with its head office in the *United Kingdom* must take account of non-credit equalisation *insurance business* carried on by it world-wide.

- 7.5.15 R** For the purposes of *PRU 7.5.12R* to *PRU 7.5.38G*, a *firm* with its head office outside the *United Kingdom* need only take account of non-credit equalisation *insurance business* carried on by it from a *branch* in the *United Kingdom*.
- 7.5.16 G** The *insurers* affected by *PRU 7.5.12R* include *pure reinsurers*, *UK–deposit insurers*, *EEA–deposit insurers*, and *Swiss general insurers*.
- 7.5.17 G** For *insurers* (including *pure reinsurers*) with a head office in the *United Kingdom*, the calculations must be made in respect of world-wide business.

REQUIREMENT TO MAINTAIN NON-CREDIT EQUALISATION PROVISION

- 7.5.18 R** In respect of each *financial year*, a *firm* must, unless *PRU 7.5.19R* applies:
- (1) calculate the amount of its *non-credit equalisation provision* as at the end of that year in accordance with *PRU 7.5.21R*; and
 - (2) maintain a *non-credit equalisation provision* calculated in accordance with *PRU 7.5.21R* for the following *financial year*.
- 7.5.19 R**
- (1) *PRU 7.5.18R* does not apply to any *firm* in respect of any *financial year* if, as at the end of that year:
 - (a) no *non-credit equalisation provision* has been brought forward from the preceding *financial year*; and
 - (b) the amount of the *annualised net written premiums* for all the non-credit equalisation *insurance business* carried on by it in the *financial year* is less than the threshold amount.
 - (2) The threshold amount in respect of any *financial year* is the higher of:
 - (a) 1,500,000 Euro; or
 - (b) 4% of *net written premiums* in that *financial year* in respect of all its *general insurance business*, if this amount is less than 2,500,000 Euro.

- 7.5.20 G For *non-EEA insurers*, the calculation of the threshold amount in *PRU 7.5.19R (2)* is limited by *PRU 7.5.15R* to the business of the *firm* carried on in the *United Kingdom*. Such a *firm* may do little UK non-credit equalisation *insurance business*, and so would not be required to set up an *non-credit equalisation provision* under *FSA* rules, but may do significant business outside the *United Kingdom* characterised by high-impact, low-frequency *claims*. Such a *firm* is required by *PRU 7.6.38 R* to hold adequate world-wide financial resources to avoid internal-contagion strain on the *branch* in the *United Kingdom*. In determining the adequacy of its financial resources, the *firm* should undertake stress and scenario testing of its underwriting and other risks as set out in *PRU 1.2*.

CALCULATING THE AMOUNT OF THE PROVISION

- 7.5.21 R (1) Unless *PRU 7.5.23R* applies, the amount of a *firm's non-credit equalisation provision* as at the end of a *financial year* is the higher of:
- (a) zero; and
 - (b) whichever is the lower of:
 - (i) the aggregate of the amounts of the maximum provision for each *insurance business grouping* as at the end of that *financial year*; and
 - (ii) the sum of A and B.
- (2) For the purposes of (1)(b)(ii):
- (a) A is the amount of the *non-credit equalisation provision*, if any, brought forward from the *financial year* immediately preceding that in respect of which the calculation is being performed ; and
 - (b) B is:
 - (i) the aggregate of the amounts of the provisional transfers-in for each *insurance business grouping*; minus
 - (ii) the aggregate of the amounts of the provisional transfers-out for each *insurance business grouping*.
- (3) For any *insurance business grouping*:
- (a) the amount of the maximum provision in (1)(b)(i) is to be determined in accordance with *PRU 7.5.25R*;
 - (b) the amount of the provisional transfers-in in (2)(b)(i) is to be determined in accordance with *PRU 7.5.27R*; and

- (c) the amount of the provisional transfers-out in (2) (b) (ii) is to be determined in accordance with **PRU 7.5.30R**.

7.5.22 G If provisional transfers-out are in excess of provisional transfers-in, the *non-credit equalisation provision* as calculated in accordance with **PRU 7.5.21R** in respect of a particular *financial year* may be less than that calculated for the preceding *financial year* although, by virtue of **PRU 7.5.21R** (1)(a), it cannot be negative.

- 7.5.23 R (1) The amount of a *firm's non-credit equalisation provision* as at the end of a *financial year* is zero if:
- (a) as at the end of that year, the *firm* meets either of the conditions specified in (2) and (3); and
 - (b) the *annualised net written premiums* for all the non-credit equalisation *insurance business* carried on by the *firm* in that year are less than the threshold amount.
- (2) The first condition is that the *firm* carried on non-credit equalisation *insurance business* in the first *financial year* of the relevant period and, for each of any two or more *financial years* of that period, the *annualised net written premiums* for business of that description were less than the threshold amount.
- (3) The second condition is that the *firm* did not carry on non-credit equalisation *insurance business* in the first *financial year* of the relevant period and the average of the *annualised net written premiums* for business of that description carried on by the *firm* in each *financial year* of the relevant period was less than the threshold amount.
- (4) For the purposes of this rule:
- (a) the threshold amount is the amount determined in accordance with **PRU 7.5.19R(2)**; and
 - (b) the relevant period is the period of four *financial years* ending immediately before the beginning of the *financial year* in (1).

7.5.24 G If **PRU 7.5.23R** applies, a *firm* may need to make sufficient transfers from its *non-credit equalisation provision* to bring the *non-credit equalisation provision* for that *financial year* to zero.

THE CALCULATION : THE MAXIMUM PROVISION

- 7.5.25 R (1) For the purposes of the calculation required by **PRU 7.5.21R**, the amount of the maximum provision for any *insurance business grouping* is to be determined in accordance with (2) to (5).
- (2) Unless (4) applies, the amount of the maximum provision for the

grouping, as at the end of a *financial year*, is the amount determined by multiplying X and Y.

- (3) For the purposes of (2):
- (a) X is the percentage specified in Table *PRU 7.5.26 R* in relation to the grouping; and
 - (b) Y is the average of the amount of the *annualised net written premiums* for non-credit equalisation *insurance business* in the grouping carried on by the *firm* in each *financial year* of the relevant period.
- (4) Where Y is a negative amount, the maximum provision for that *insurance business grouping* is zero.
- (5) For the purposes of (3)(b), the relevant period is the five-year period comprising:
- (a) the *financial year* in (2); and
 - (b) the previous four *financial years*.

7.5.26 R Table : Calculation of Maximum Provision for any *insurance business grouping*

<i>Insurance Business Grouping</i>	Percentage of average <i>annualised net written premiums</i>
A	20
B	20
C	40
D	600
E	75

THE CALCULATION : PROVISIONAL TRANSFERS-IN

- 7.5.27 R** (1) For the purposes of the calculation required by *PRU 7.5.21R*, the amount of the provisional transfers-in for any *insurance business grouping* is to be determined in accordance with (2)
- (2) The amount of the provisional transfers-in for the grouping, as at the end of a *financial year*, is the amount determined by multiplying X and Y.
- (3) For the purposes of (2):
- (a) X is the percentage specified in Table *PRU 7.5.28 R* in relation to the grouping; and

- (b) Y is the amount of the *net written premiums* for non-credit equalisation *insurance business* in the grouping that was carried on by the *firm* in the *financial year* in (2), including adjustments in respect of previous *financial years*.

7.5.28 R Table : Provisional transfers-in for any *insurance business grouping*

<i>Insurance Business Grouping</i>	Percentage of <i>net written premiums</i>
A	3
B	3
C	6
D	75
E	11

7.5.29 G Since each *insurance business grouping* should be assessed individually, negative *net written premiums* in relation to any *insurance business grouping* should be transferred in to the *non-credit equalisation provision*.

THE CALCULATION : PROVISIONAL TRANSFERS-OUT

7.5.30 R (1) For the purposes of the calculation required by *PRU 7.5.21R*, the amount of the provisional transfers-out for any *insurance business grouping* is to be determined in accordance with (2).

(2) The amount of the provisional transfers-out for the grouping, as at the end of a *financial year*, is the lower of:

(a) the amount of the maximum provision for the grouping under *PRU 7.5.25R* for that *financial year*; and

(b) the abnormal loss for the grouping under *PRU 7.5.31R* for that *financial year*.

7.5.31 R For each *insurance business grouping*, the abnormal loss as at the end of a *financial year* in relation to which an *equalisation provision* is calculated is:

(1) (for business within the *insurance business grouping* accounted for on an accident year basis) the amount, if any, by which the amount of net *claims* incurred exceeds the greater of:

(a) zero; and

(b) the percentage of *net earned premiums* in that *financial year* specified in the Table in 7.5.32R, or

- (2) (for business within the *insurance business grouping* accounted for on an underwriting year basis) the amount, if any, by which the amount of net *claims* paid (plus adjustment for change in net technical provisions, other than any change in provisions for claims handling expenses or equalisation) exceeds the greater of:
- (a) zero; and
 - (b) the percentage of *net written premiums* in that *financial year* specified in the Table in 7.5.32R.

7.5.32 R Table : Abnormal loss for any *insurance business grouping*

<i>Insurance business grouping</i>	Percentage of <i>net written premiums</i>
A	72.5
B	72.5
C	95
D	25
E	100

ADJUSTMENTS TO CALCULATIONS

TRANSFERS OF BUSINESS FROM THE FIRM

- 7.5.33 R** (1) This *rule* applies to modify the application of *PRU 7.5.25R* and *PRU 7.5.31R* in any case where a *firm* has transferred to another undertaking any rights and obligations under *general insurance contracts* falling within any *insurance business grouping*.
- (2) As at the end of the *financial year* in which the transfer takes place, *net written premiums* in respect of the transferred contracts in any grouping must be deducted from total *net written premiums* for that grouping before calculating the maximum provision under *PRU 7.5.25R* or provisional transfers-in under *PRU 7.5.27R*.

- 7.5.34 R** If all the rights and obligations of a *firm* in relation to non-credit equalisation *insurance business* in any *insurance business grouping* have been transferred, the maximum provision for the grouping under *PRU 7.5.25R* is zero.

TRANSFERS OF BUSINESS TO THE FIRM

- 7.5.35 R** (1) This *rule* applies to modify the application of *PRU 7.5.21R*, *PRU 7.5.27R* and *PRU 7.5.30R* in any case where another undertaking has transferred to a *firm* any rights and obligations under *general insurance contracts* falling within any *insurance*

business grouping.

(2) As at the end of the *financial year* in which the transfer takes place a sum equal to that part of the consideration for the transfer that relates to business in an *insurance business grouping* must be:

- (a) excluded from net *premiums* (written or earned) before performing the calculations required by *PRU 7.5.25 R* (maximum provision) and *PRU 7.5.27 R* (provisional transfers in);**
- (b) included in net *premiums* (written or earned) before performing the calculation required by *PRU 7.5.31R* (abnormal loss); and**
- (c) excluded from net *claims* (paid or incurred) before performing the calculation required by *PRU 7.5.31R* (abnormal loss).**

- 7.5.36 G For the purposes of *PRU 7.5.35R*, the consideration payable should be apportioned between *insurance business groupings* according to the groupings within which the *general insurance contracts* which are the subject of the acquisition fall. In appropriate cases, apportionment may reflect the split of liabilities acquired, including *unearned premium*.
- 7.5.37 G Where business is accounted for on an accounting year basis, in any year following the transfer, *net earned premiums* must include an appropriate amount in respect of the transfer.
- 7.5.38 G *PRU 7.5.33R* to *PRU 7.5.35R* apply to transfers by way of transfer under Part VII of the Act and by novation.

Credit Equalisation Provisions

FIRMS CARRYING ON CREDIT INSURANCE BUSINESS

7.5.39 R *PRU 7.5.39R* to *PRU 7.5.48G* apply to:

- (1) any *UK insurer*; or**
- (2) any *non-EEA direct insurer*;**

which carries on the business of *effecting or carrying out general insurance contracts* falling within *general insurance business class 14* ("*credit insurance business*").

- 7.5.40 R** For the purposes of PRU 7.5.44R, a *UK insurer* other than a *pure reinsurer* with its head office in the *UK* must take account of the credit *insurance business* carried on by it world-wide
- 7.5.41 R** (1) For the purposes of *PRU 7.5.44R*:
- (a) a *Swiss general insurer* or an *EEA-deposit insurer* must take account of the credit *insurance business* carried on by it in the *United Kingdom*;
 - (b) a *UK- deposit insurer* must take account of the credit *insurance business* carried on by it worldwide.
- (2) For the purposes of *PRU 7.5.45R*:
- (a) a *UK deposit insurer* need only take account of the credit *insurance business* carried on by it in all *EEA States*, taken together; and
 - (b) any other description of *non-EEA direct insurer* (including an *EEA-deposit insurer* and a *Swiss general insurer*) need only take account of the credit *insurance business* carried on by it in the *United Kingdom*.
- 7.5.42 G** For *UK insurers* the calculations must be made in respect of world-wide business
- 7.5.43 G** The requirements of *PRU 7.5.40R* are summarised in the table in *PRU 7.5.8 G*.

REQUIREMENT TO MAINTAIN CREDIT EQUALISATION PROVISION

- 7.5.44 R** In respect of each *financial year*, a *UK insurer* or a *non-EEA direct insurer* must, unless *PRU 7.5.45R* applies:
- (1) calculate the amount of its *credit equalisation provision* as at the end of that year in accordance with *PRU 7.5.46R*; and
 - (2) maintain a *credit equalisation provision* calculated in accordance with *PRU 7.5.46R* for the following *financial year*.
- 7.5.45 R** *PRU 7.5.44R* does not apply to any *UK insurer* or a *non-EEA direct insurer* in respect of any *financial year* if, as at the end of that year, the *annualised net written premiums* for its credit *insurance business* are less than 4% of annualised *net written premiums* in that *financial year* in respect of all its *general insurance business*, if this amount is less than 2,500,000 Euro.

CALCULATING THE AMOUNT OF THE PROVISION

- 7.5.46 R (1)** The amount of a *UK insurer's*, or a *non-EEA direct insurer's*, *credit equalisation provision* as at the end of a *financial year* ("*financial year A*") is the higher of:
- (a) zero; and
 - (b) whichever is the lower of:
 - (i) 150% of the highest amount of *net written premiums* for *credit insurance business* carried on by the *insurer* in *financial year A* or in any of the previous four *financial years*; and
 - (ii) the amount of the *credit equalisation provision* brought forward from the preceding *financial year*, after making either of the adjustments in (2).
- (2)** The adjustments are:
- (a) the deduction of the amount of any technical deficit arising in *financial year A*; or
 - (b) the addition of the higher of:
 - (i) 75% of the amount of any technical surplus arising in *financial year A*; or
 - (ii) 12% of the amount of the *net written premiums* for *credit insurance business* carried on by the *insurer* in *financial year A*.
- (3)** For the purposes of (2) the amount of technical deficit or technical surplus is to be determined in accordance with *PRU 7.5.47R*.
- 7.5.47 R** For the purposes of the adjustments in *PRU 7.5.46R* (2), technical surplus (or technical deficit) in respect of *credit insurance business* is the amount by which the aggregate of *net earned premiums* exceeds (or falls short of) the sum of net *claims* incurred, *claims* management costs and any technical charges.
- 7.5.48 G** The calculation of technical surplus or technical deficit should be made before tax and before any transfer to or from the *credit equalisation provision*. Investment income should not be included in these calculations.

7.6 Internal-contagion risk

APPLICATION

- 7.6.1 R** This section applies to every *insurer*.
- 7.6.2 R** This section does not apply to the extent stated to any person within (1) to (4):
- (1) none of the provisions apply to *non-directive friendly societies*,
 - (2) none of the provisions, apart from *PRU 7.6.30R* (payment of financial penalties) apply to *firms* which qualify for authorisation under Schedules 3 and 4 of the *Act*;
 - (3) *PRU 7.6.30R* (payment of financial penalties) does not apply to *mutuals*;
 - (4) *PRU 7.6.38R* to *PRU 7.6.53R* (*UK branches* of certain *non-EEA insurers*) do not apply to:
 - (a) *UK insurers*;
 - (b) *Non-EEA insurers* which are *pure reinsurers*;
 - (c) *EEA deposit insurers*; or
 - (d) *Swiss General insurers*.
- 7.6.3 G** The scope of application of *PRU 7.6* is not restricted to *firms* that are subject to the relevant EC directives. It applies, for example, to *pure reinsurers*.
- 7.6.4 R** In its application to a *firm* with its head office in the *United Kingdom*, this section applies to the whole of the *firm's* business carried on world-wide.
- 7.6.5 R** In the application of this section to activities carried on by a *non-EEA insurer*:
- (1) *PRU 7.6.13G* to *PRU 7.6.16G* and *PRU 7.6.38R* apply in relation to the whole of its business carried on world-wide;
 - (2) all other provisions of this section apply only in relation to:
 - (a) in the case of any *UK-deposit insurer*, activities carried on from *branches* in any *EEA State*; and
 - (b) in any other case activities carried on from a *branch* in the *United Kingdom*.

- 7.6.6 G The adequacy of a *firm's* financial resources needs to be assessed in relation to all the activities of the *firm* and the risks to which they give rise.
- 7.6.7 G The requirements of this section apply to a *firm* on a solo basis.

PURPOSE

- 7.6.8 G This section sets out requirements for a *firm* relating to 'internal-contagion risk'. This is the risk that losses or liabilities from one activity might deplete or divert financial resources held to meet liabilities from another activity. It arises where the two activities are carried on within the same *firm*. It may also arise from the combination of activities within the same *group*, but this aspect of internal-contagion risk falls outside the scope of this section. Requirements relevant to *group* contagion risk are set out in *PRU 8*.
- 7.6.9 G Internal-contagion risk includes in particular the risk that arises where a *firm* carries on:
- (1) both insurance and non-insurance activities; or
 - (2) two or more different types of insurance activity; or
 - (3) insurance activities from offices or *branches* located in both the *United Kingdom* and overseas.
- 7.6.10 G This section requires *firms* to limit non-insurance activities to those that directly arise from their *insurance business*, e.g. investing assets, employing insurance staff etc. It also requires that an adequate provision be established for non-insurance liabilities.
- 7.6.11 G This section also sets out requirements for the separation of different types of insurance activity. However in most circumstances the combination of different types of insurance activity within the same *firm* is a source of strength. Adequate pooling and diversification of insurance risk is fundamental to sound business practice. The requirements, therefore, only apply in two specific cases where without adequate protection the combination might operate to the detriment of *policyholders*. They apply where a *firm* carries on both:
- (1) *general insurance business* and *long-term insurance business*;
 - (2) linked and non-linked *insurance business*.
- 7.6.12 G Finally the section sets out requirements to protect *policyholders* of *branches* of non-EEA *firms* where these are supervised by the *FSA*. These apply only to a non-EEA *firm* that has established a *branch* in the *United Kingdom*.

REQUIREMENTS: NON-INSURANCE ACTIVITIES

- 7.6.13 G Exposure to non-insurance activities arises because liabilities from those activities might exceed the levels expected or fall due earlier than expected or because assets related to those activities may realise less than expected or be realised later than expected. This may have an impact upon a *firm's* ability to meet its *insurance liabilities*.

RESTRICTION OF BUSINESS TO INSURANCE

- 7.6.14 R (1) **A *firm* must not carry on any commercial business other than *insurance business* and activities directly arising from that business.**
- (2) **(1) does not prevent a *friendly society* which was on 15 March 1979 carrying on *long-term insurance business* from continuing**

to carry on savings business.

FINANCIAL LIMITATION OF NON-INSURANCE ACTIVITIES

- 7.6.15 R** A *firm* must limit, manage and control its non-insurance activities so that there is no significant risk arising from those activities that it may be unable to meet its liabilities as they fall due.
- 7.6.16 G For the purpose of PRU 7.6.15R a *firm* should consider how the financial impact of non-insurance activities might diverge from expectations. However it need only take into account unexpected variations in amount and timing in so far as they are reasonably possible and may take into account effective mitigating factors.

REQUIREMENTS: LONG-TERM INSURANCE BUSINESS

- 7.6.17 G PRU 7.6.21R, PRU 7.6.27R and PRU 7.6.28R require a *firm* to identify the assets attributable to the receipts of the *long-term insurance business*, called *long-term insurance assets*, and only to apply those assets for the purpose of that business. This has the effect of prohibiting a *composite firm* from using *long-term insurance assets* to meet general insurance liabilities. It also keeps *long-term insurance assets* separate from shareholder funds.

PERMISSIONS NOT TO INCLUDE BOTH TYPES OF INSURANCE

- 7.6.18 G Under section 31 of the *Act*, a *firm* may not carry on a regulated activity unless it has *permission* to do so (or is exempt from doing so). Both *general insurance business* and *long term insurance business* are regulated activities. It is FSA policy, in compliance with the EC directives on insurance not to grant *permission* whereby one *firm* would be *effecting or carrying out* both *general insurance business* and *long-term insurance business*, except where the new *permission(s)* is restricted to reinsurance. Where a *firm* already has *permissions* to *effect or carry out general insurance business or long-term insurance business*, the existing *permissions* can be varied. However, *permission to effect and carry out life and annuity contracts of insurance* automatically includes *permission to effect and carry out accident or sickness contracts of insurance* on an ancillary or supplementary basis (Article 2 (1) (c) of *Life Assurance Directive*)

SEPARATELY IDENTIFY AND MAINTAIN LONG TERM INSURANCE ASSETS

- 7.6.19 G PRU 7.2.17R requires a *firm* to establish adequate *technical provisions* for its *long-term insurance contracts*. PRU 7.2.21R requires a *firm* to hold *admissible assets* of a value at least equal to the amount of the *technical provisions*. PRU 7.2.22R ensures that a *composite firm* identifies separate *long-term insurance assets* with a value at least equal to the *technical provisions* for *long-term insurance business* as well as holding other assets of a value at least equal to the amount of its *technical provisions* for *general insurance business*. The overall impact of this is that any *firm* writing *long-term insurance business* must identify separately its *long-term insurance assets* and ensure that their value is at least equal to the amount of its *long-term insurance business technical provisions*.

- 7.6.20 G *Firms must ensure that long-term insurance assets are separately identified and allocated to the long-term insurance fund at all times. Assets in external accounts, for example at banks, custodians, or brokers should be segregated into separate accounts for long-term insurance business and general insurance business. Where a firm has more than one long-term insurance fund, a separate account must be maintained for each fund. Accounting records should clearly document the allocation.*
- 7.6.21 R **A firm carrying on long-term insurance business must separately identify the assets relating to that business which it is required to hold by virtue of PRU 7.2.21 R to PRU 7.2.22R and must include within these assets:**
- (1) **those assets identified as long-term insurance assets (including assets into which those assets have been converted);**
 - (2) **premiums and other receivables in respect of long-term insurance contracts;**
 - (3) **income and capital receipts from long-term insurance assets; and**
 - (4) **other receipts of the long-term insurance business.**
- 7.6.22 R (1) **A firm carrying on long-term insurance business which has more than one separately identified long-term insurance fund must maintain a separate account in respect of each separately identified long-term insurance fund.**
- (2) **The receipts for each long-term insurance fund must be entered in an account maintained for that business and must be carried to and form a separate long-term insurance fund.**
- 7.6.23 G *PRU 7.6.21R does not prohibit a firm from identifying other assets under PRU 7.2.21R as long-term insurance assets (that is, as available to meet the liabilities of its long-term insurance business). This allows a firm to transfer assets to the fund of long-term insurance assets. Such a transfer takes effect when it is recorded in the firm's accounting records. After it takes effect, a firm may not transfer the assets out of the long-term insurance fund except where they represent an established surplus.*
- 7.6.24 R **Except in the case of a with-profits fund PRU 7.6.21R does not apply to assets that represent an established surplus.**
- 7.6.25 G *An actuarial investigation undertaken to determine an established surplus remains in-date for three months from the date as at which the determination was made. However even where the investigation is still in-date the firm should not make the transfer unless there is sufficient surplus at the time of the transfer to allow it to be made without breach of PRU 7.2.21R.*

- 7.6.26 G Additional provisions on distributions from a *with-profits fund* are contained in COB 6.12 (Treating with-profits policyholders fairly). PRU 7.2.29R requires a *realistic basis life firm* to maintain *admissible assets* in the *with-profits fund* to cover the value of the realistic liabilities of that fund. This rule acts as an additional constraint on the amount that may be transferred out of a *with-profits fund*.

EXCLUSIVE USE OF LONG-TERM INSURANCE ASSETS

- 7.6.27 R (1) **A firm must apply a long-term insurance asset only for the purposes of its long-term insurance business.**
- (2) **For the purpose of (1), applying an asset includes coming under any obligation (even if only contingently) to apply that asset.**
- 7.6.28 R **A firm must not agree to, or allow, any mortgage or charge on its long-term insurance assets other than in respect of a long-term insurance liability.**
- 7.6.29 G The purposes of the *long-term insurance business* include the payment of *claims*, expenses and liabilities arising from that business, the acquisition of lawful access to fixed assets to be used in that business and the investment of assets. The payment of liabilities may include repaying a loan but only where that loan was incurred for the purpose of the *long-term insurance business*. The purchase or investment of assets may include an exchange at fair *market value* of assets (including *money*) between the *long-term insurance fund* and other assets of the *firm*.

PAYMENT OF FINANCIAL PENALTIES

- 7.6.30 R **If the FSA imposes a financial penalty on a long-term insurer the firm must not pay that financial penalty from a long-term insurance fund.**
- 7.6.31 G PRU 7.6.2R states that this provision applies to all *firms*, except *mutuals*, and includes *firms* qualifying for authorisation under Schedules 3 or 4 to the *Act*.

REQUIREMENTS: PROPERTY-LINKED FUNDS

- 7.6.32 G PRU 4.2.60R requires a *firm* to cover, as closely as possible, its *property-linked liabilities* by the property to which those liabilities are linked. In order to comply with this rule a *firm* should identify the assets it holds to cover *property-linked liabilities* and should not apply those assets (as long as they are needed to cover the *property-linked liabilities*) for any purpose other than to meet those liabilities.
- 7.6.33 R **A firm must select, allocate and manage the assets to which its property-linked liabilities are linked taking into account:**
- (1) **the firm's contractual obligations to holders of property-linked policies; and**
- (2) **its regulatory duty to treat customers fairly, including in the way it makes discretionary decisions as to how it selects, allocates and manages assets.**

- 7.6.34 G *Property-linked liabilities* may be linked either to specified assets (with no contractual discretion given to the *firm* as to the choice of assets) or to assets of a specified kind where the selection of the actual assets is left to the *firm*.

REQUIREMENTS: UK BRANCHES OF CERTAIN NON-EEA FIRMS

- 7.6.35 G The purpose of the *rules* and *guidance* set out in *PRU 7.6.35G* to *PRU 7.6.53R* is to protect against the risk that the financial resources required in respect of the activities of the *United Kingdom* (or *EEA*) *branch(es)* might be depleted by the other activities of the *non-EEA direct insurer*.
- 7.6.36 G By virtue of *PRU 7.6.2R(4)* the rules in *PRU 7.6.38R* to *7.6.53R* apply to *non-EEA direct insurers* except for *Swiss general insurers* and *EEA-deposit insurers*. Responsibility for determining the adequacy of the world-wide financial resources of *Swiss general insurers* or *EEA-deposit insurers* rests exclusively with the Swiss authorities or the authorities in the *EEA state* (other than the *United Kingdom*) in which the deposit was made.
- 7.6.37 G
- (1) *PRU 7.6.38R* requires a *non-EEA direct insurer* to hold adequate world-wide resources to meet the needs of the world-wide business without the need to rely on *UK* or *EEA branch* assets other than to meet *branch* liabilities.
 - (2) *PRU 7.6.39R* to *PRU 7.6.44R* require *non-EEA direct insurers* to calculate a local *MCR* and to hold assets representing that requirement in the *EEA* or the *UK*.
 - (3) *PRU 7.6.45R* to *PRU 7.6.48R* require *non-EEA direct insurers* to deposit a minimum level of assets in the *UK* or *EEA*.
 - (4) *PRU 7.6.50R* requires the deposit of a minimum level of assets in the *UK*.
 - (5) *PRU 7.6.52R* to *PRU 7.6.53R* require *non-EEA direct insurers* to keep adequate accounting records in the *United Kingdom*.

WORLDWIDE FINANCIAL RESOURCES

- 7.6.38 R
- (1) **A *non-EEA direct insurer* must maintain adequate worldwide financial resources, to ensure that there is no significant risk that its liabilities cannot be met as they fall due.**
 - (2) **For the purpose of (1):**
 - (a) **a *UK-deposit insurer* must not rely upon the assets held under *PRU 7.2.21R* as available to meet liabilities other than those arising from the activities of its *branches* in *EEA States*;**
 - (b) **other *non-EEA direct insurers* to whom (1) applies must not rely upon the assets held under *PRU 7.2.21R* as available to meet liabilities other than those arising from the activities of any *UK branch*.**

TECHNICAL PROVISIONS AND UK OR EEA MCR TO BE COVERED BY ADMISSIBLE ASSETS

- 7.6.39 R **A *non-EEA direct insurer* must:**

- (1) calculate a *UK* or *EEA MCR* in accordance with *PRU 7.6.41 R* to *PRU 7.6.44 R*.
 - (2) hold *admissible assets* (in addition to those required under *PRU 7.2.21*) to represent its *UK* or *EEA MCR* calculated under (1).
- 7.6.40 R The assets held under (2) must be identified and valued as if the *non-EEA direct insurer* was a *firm* with its head office in the *UK*.
- 7.6.41 R For the purposes of *PRU 7.6.39 R* a *non-EEA direct insurer* (except a *UK deposit insurer*) must calculate a *UK MCR*:
- (1) for *long-term insurance business*, in accordance with *PRU 7.2.82R – PRU 7.2.92R* but only in relation to business carried on by the *firm* in the *United Kingdom*;
 - (2) for *general insurance business*, in accordance with *PRU 7.2.46R* to *PRU 7.2.73R* but only in relation to business carried on by the *firm* in the *United Kingdom*.
- 7.6.42 R For a *composite firm* the *UK MCR* is the sum of the amounts arrived at under *PRU 7.6.41R*(1) and (2).
- 7.6.43 R For the purposes of *PRU 7.6.39R* a *UK deposit insurer* must calculate an *EEA MCR*:
- (1) for *long-term insurance business*, in accordance with *PRU 7.2.82R – PRU 7.2.92 R* but only in relation to business carried on by the *firm* in all *EEA States*, taken together;
 - (2) for *general insurance business*, in accordance with *PRU 7.2.46R* to *PRU 7.2.73G* but only in relation to business carried on in all *EEA States*, taken together.
- 7.6.44 R For a *composite firm* the *EEA MCR* is the sum of the amounts arrived at under *PRU 7.6.43 R* (1) and (2).

LOCALISATION OF ASSETS

- 7.6.45 R A *non-EEA direct insurer* (except a *UK-deposit insurer*) must hold *admissible assets*, which are required to cover its *technical provisions* in accordance with *PRU 7.2.21R* and to represent its *UK MCR* calculated under *PRU 7.6.41R*:
- (1) (where the assets cover the *technical provisions* and the *guarantee fund*), in the *United Kingdom*;
 - (2) (where the assets represent the amount of the *UK MCR* in excess of the *guarantee fund*) in any *EEA State*.

7.6.46 R *A UK deposit insurer must hold **admissible assets**, which are required to cover its **technical provisions** in accordance with PRU 7.2.21R and to represent its **EEA MCR** calculated under PRU 7.6.43R:*

- (1) (where the assets cover the **technical provisions** and the **guarantee fund**), within the **EEA** states where the **firm** carries on insurance business;
- (2) (where the assets represent the amount of the **EEA MCR** in excess of the **guarantee fund**), in any **EEA State**.

7.6.47 G The *admissible assets* in excess of the *technical provisions* and *UK* or *EEA MCR* may be held outside the *EEA*.

7.6.48 R For the purpose of PRU 7.6.45R and PRU 7.6.46R:

- (1) a **tangible asset** is to be treated as held in the country or territory where it is situated;
- (2) An **admissible asset** consisting of a **claim** against a debtor is to be regarded as held in any country or territory where it can be enforced by legal action;
- (3) a **listed security** is to be treated as held in any country or territory where there is a **regulated market** in which the security is dealt; and
- (4) a security which is not a **listed security** is to be treated as held in the country or territory in which the **issuer** has its head office.

7.6.49 G PRU 4.2.53R to PRU 4.2.58R (currency matching of assets and liabilities) apply to the assets held to match *insurance liabilities* calculated under PRU 7.2.13R or PRU 7.2.17R.

DEPOSIT OF ASSETS AS SECURITY

7.6.50 R *A non-EEA direct insurer must keep assets of a value at least equal to one half of the **base capital resources requirement** on deposit in the United Kingdom with a **BCD credit institution**.*

7.6.51 G The assets deposited as security may count towards the assets required under PRU 7.6.45R and PRU 7.6.46R. If, after the deposit is made, the value of the deposited assets falls below the *base capital resources requirement*, the *firm* should deposit further *admissible assets* in order to comply with PRU 7.6.45R and PRU 7.6.46R. Deposited assets may be exchanged for other *admissible assets* and excess assets may be withdrawn, provided that the exchange or deposit does not cause a breach of PRU 7.6.45R or PRU 7.6.46R.

BRANCH ACCOUNTING RECORDS IN THE UK

7.6.52 R *A non-EEA direct insurer must maintain at a place of business in the United Kingdom adequate records relating to:*

- (1) the activities carried on from its **United Kingdom branch**; and

- (2) if it is an *EEA-deposit insurer*, the activities carried on from the *branches* in other *EEA States*.

7.6.53 R The records maintained as required by *PRU 7.6.52R* must include a record of:

- (1) the income, expenditure and liabilities arising from activities of the *branch* or *branches*; and
- (2) the assets identified under *PRU 7.2.21R* as available to meet those liabilities.

Amendments to the Interim Prudential sourcebook for insurers,

Volume 1, Chapter 9 and Volume 2, Appendices 9.1 and 9.6

VOLUME 1

Chapter 9

FINANCIAL REPORTING

CONTENTS

...

9.3A Half-yearly balance sheet and report for realistic valuation

9.31 ~~Periodic actuarial investigation~~ Valuation reports on long-term insurance business

9.34 Certificates of Directors

Part I

ACCOUNTS AND STATEMENTS

Half-yearly balance sheet and report for realistic valuation

9.3A (1) Every *long-term insurer* which is a *realistic basis life firm* must in respect of each *financial year* prepare **Forms 9, 18 and 19** of **Appendix 9.1**, as at the end of the first six months of that *financial year*.

(2) The **Forms** in (1) must be prepared in accordance with **Appendix 9.1** and must be completed in respect of each of the *firm's with profits funds*.

(3) The **Forms** in (1) must be accompanied by a report (instead of the reports required under 9.4(1)(b)) identifying any changes to the methods and assumptions used from those set out in the report for the realistic valuation as at the end of the *preceding financial year*.

(4) Rules 9.4, 9.6, 9.10, 9.11, 9.12, 9.33 and 9.34, **Appendices 9.1** and **9.4A** and **Part I** of **Appendix 9.6** apply to this rule and to any documents required under this rule as if -

(a) an additional balance sheet were required under rule 9.3;

(b) the documents required by (1) were required by rule 9.12 for the

- purposes of the balance sheet in (a) above;
- (c) an additional investigation were required under rule 9.4 in respect of the six-month period covered by this rule;
 - (d) any document required by (3) were a document required by rule 9.31(b) for the purposes of the investigation in (c) above;
 - (e) any reference to the *financial year in question* (however expressed) were a reference to the six-month period referred to in (1);
 - (f) any reference to the preceding year were a reference to the end of the *preceding financial year*;
 - (g) the required signatory in each case were any director of the *insurer*;
 - (h) any reference to a particular amount shown in a document not required under (1) or (3) were a reference to the amount which would be shown in that document (subject to any modifications in (a) to (f) above) in accordance with the *Accounts and Statements Rules* if that document were required to be produced; and
 - (i) any requirement (other than in this rule) to refer in the *return* or the *certificate* in **Appendix 9.6** to a document not required under (1) or (3) were omitted.
- (5) Instead of a valuation report under rule 9.31(a), the report referred to in (3) must include, in an additional numbered answer following the answers to the paragraphs in **Appendix 9.4A**–
- (a) a full description of each of the changes in the methods and assumptions used in the investigation for the purposes of rule 9.4(2)(a) and (b) since the previous investigation at the end of the *preceding financial year*; or
 - (b) if there has been no such change, a statement to that effect.
- (6) Rules 9.3, 9.5, 9.7, 9.13 to 9.30, 9.31, 9.32 and 9.35 to 9.39 do not apply in respect of the documents required under this rule.

Periodic actuarial investigation of long-term insurer

9.4 (1) Every *long-term insurer* –

- (a) must, once in every period of 12 months, cause an investigation to be made into its financial condition in respect of its *long-term insurance business*, in accordance with the methods and assumptions determined by the *insurer*, by the person or persons who for the time being ~~is its appointed actuary~~ are appointed to perform the *actuarial function* under the rules in *SUP*; and
- (b) when such an investigation has been made, or when at any other time

an investigation into the financial condition of the *insurer* in respect of its *long-term insurance business* has been made with a view to the distribution of profits, or the results of which are made public, must cause an abstract of the ~~appointed-actuary's report or reports~~ of the investigation to be made.

- (2) An investigation to which (1)(b) relates must include –
- (a) a determination of the liabilities of the *insurer* attributable to its *long-term insurance business*; ~~and~~
 - (b) a valuation of any excess over those liabilities of the assets representing the *long-term insurance fund* or *funds* and, where any rights of any long-term *policy holders* to participate in profits relate to particular parts of such a fund, a valuation of any excess of assets over liabilities in respect of those parts; and
 - (c) for every long-term insurer which is a realistic basis life firm, a calculation of the with-profits insurance capital component.
- (3) For the purposes of any investigation to which this rule applies, the value of any assets and the amount of any liabilities must be determined in accordance with ~~the Valuation of Assets Rules PRU 1.3 and the Determination of Liabilities Rules PRU 7.~~
- (4) The form and contents of any abstract under this rule must be in accordance with ~~the Accounts and Statements Rules~~ rule 9.31.

Audit of accounts

- 9.5 (1) The 'accounts and balance sheets' of every *insurer* must be audited in accordance with rule 9.35 by a person qualified in accordance with the rules in *SUP*.
- (2) In (1), the reference to **accounts and balance sheets** includes a reference to any notes or statement or report annexed to them, save for -
- (a) the directors' certificate annexed pursuant to rule 9.34, and
 - (b) Forms 46 to 47A, 50 to 55, 57 and 59.

Value of assets and amount of liabilities

- 9.10 Unless otherwise provided in the *Accounts and Statements Rules*, in the documents which an *insurer* is required to prepare in accordance with the *Accounts and Statements Rules* —~~(a) the value or amount given for an asset (other than a linked asset not required to be valued in accordance with the Valuation of Assets Rules by virtue of rule 4.1(2)) or a liability of the insurer is the value or amount of that asset or liability as determined in accordance with the PRU 1.3 Valuation of Assets Rules and the Determination of Liabilities Rules PRU 7 at the end of the financial year in question; and~~

- (b) ~~in the case of a *linked asset* of the *insurer* (other than a *linked asset* required to be valued in accordance with the *Valuation of Assets Rules* by virtue of rule 4.1), the value given is the value of that asset as determined in accordance with generally accepted accounting concepts, bases and policies or other generally accepted methods appropriate for *insurers*.~~

Balance sheet

- 9.12 (1) The balance sheet required to be prepared by an *insurer* under rule 9.3(1) must comply with the requirements of **Appendix 9.1** and must be in **Forms 9 to 15** and **17 to 19** of that Appendix completed (as may be appropriate) as specified in (2) to (89).

...

- (9) **Forms 18 and 19** must be completed by every *long-term insurer* which is a *realistic basis life firm*, in respect of each of its *with profits funds*.

Periodic actuarial investigation Valuation reports on long-term insurance business

- 9.31 ~~Save in relation to (b), for~~ For the purposes of rule 9.4, *treating ordinary long-term insurance business and industrial assurance business* must be treated separately, and the Every *insurer* which carries on *long-term insurance business* must prepare and annex to the documents referred to in rules 9.12, 9.13 and 9.14 -

- (a) for the purposes of rule 9.4 other than in relation to the calculation required by rule 9.4(2)(c), a valuation ~~the abstract of the report, of the appointed actuary on the long-term insurance business which, – treating ordinary long-term insurance business and industrial assurance business separately, must comply~~ complies with the requirements of **Appendix 9.4** and ~~must~~ contains the information (together with such of **Forms 46 to 49** and **51 to 58** as may be appropriate) specified in that Appendix; and

- (b) for the purposes of rule 9.4 in relation to the calculation required by rule 9.4(2)(c) (if applicable), a valuation report for the realistic valuation, which, complies with the requirements of **Appendix 9.4A** and contains the information specified in that Appendix; and

- (c) except in the case of an *EEA-deposit insurer*, ~~must also include **Form 60** and, where appropriate, **Form 61**.~~

Certificates by Directors

- 9.34 There must be annexed to the documents referred to in rules 9.12, 9.13 and 9.14 ~~(a)~~ a certificate in accordance with the requirements of Part I of **Appendix 9.6** which must be signed by the persons required by rule 9.33 to sign the documents to which the certificate relates; ~~and,~~

- (b) ~~in the case of an *insurer* which has at any time during the *financial year in question* carried on *long term insurance business*, a certificate in accordance with the requirements of Part II of **Appendix 9.6** which must be signed by the *appointed actuary*.~~

Audit and auditor's report

- 9.35 (1) The documents referred to in rules 9.12, 9.13 and 9.14, together with **Forms 40 to 45, 48, 49, 56, 58 and 60**, and every statement, analysis, or report or certificate annexed pursuant to rules 9.24 to 9.27, 9.29 and 9.31 9.34(a) must be audited by a person, in accordance with the rules in *SUP*, who must make and annex to those documents a report in accordance with the requirements of Part II ~~III~~ of **Appendix 9.6**.
- (1A) For the purposes of rule 9.5 and (1) and **Appendix 9.6**, to the extent that any document, Form, statement, analysis or report to be audited under (1) contains amounts or information abstracted from the *actuarial investigation* performed pursuant to rule 9.4, the auditor must obtain and pay due regard to advice from a suitably qualified *actuary* who is independent of the *insurer*.

VOLUME 2

CONTENTS

Appendix 9.1 Balance sheet and profit and loss account (Forms 9 to ~~179~~) (rules 9.12 and 9.13)

Appendix 9.4A Abstract of valuation report for realistic valuation (rule 9.31(b))

Appendix 9.6 Certificates by directors ~~and actuary~~ and report of the auditors (rules 9.34 and 9.35)

APPENDIX 9.1 (rules 9.12 and 9.13)

BALANCE SHEET AND PROFIT AND LOSS ACCOUNT (FORMS 9 TO ~~179~~)

Introduction

1. (1) All the forms included in the part of the *return* to which the Appendix relates (**Forms 9 to ~~179~~**) are to be laid out as shown in this Appendix, except that the instructions for the completion of the form need not be reproduced.

APPENDIX 9.6 (rules 9.34 and 9.35)

In Appendix 9.6, paragraphs 1 to 4 and their heading are replaced with new paragraphs 1 to 4 as follows. Paragraph 5 below amends the current paragraph 12. Additions to the text compared with the current IPRU(INS) are underlined, deletions are crossed through. Paragraphs 6 to 12 and their headings are deleted.

CERTIFICATES BY DIRECTORS ~~AND ACTUARY~~ AND REPORTS OF THE AUDITORS

Part I

Certificate by directors ~~etc.~~

1. (1) Subject to 3, the certificate required by rule 9.34 must state -
 - (a) that the *return* has been properly prepared in accordance with the requirements in *IPRU(INS)* and *PRU*; and
 - (b) that the *directors* are satisfied that:
 - (i) throughout the *financial year in question*, the *insurer* has complied with the requirements in *SYSC* and *PRIN* as well as the provisions of *IPRU(INS)* and *PRU*; and

(ii) it is reasonable to believe that the *insurer* has continued so to comply subsequently, and will continue so to comply in future.

(2) An *insurer* does not comply in all material respects with the requirements specified in (1)(b) if it commits a breach of any of those requirements which is significant, having regard to potential financial loss to policyholders or to the *insurer*, frequency of the breach, implications for the *insurer's* systems and controls and if there were any delays in identifying or rectifying the breach.

2. Subject to 3, if the *insurer* carries on *long-term insurance business*, the certificate required by rule 9.34 must also state that -

(a) in the *directors'* opinion, premiums for contracts entered into during the *financial year* and the resulting income earned are sufficient, under reasonable actuarial methods and assumptions, and taking into account the other financial resources of the *insurer* that are available for the purpose, to enable the *insurer* to meet its obligations in respect of those contracts and, in particular, to establish adequate *mathematical reserves*;

(b) the sum of the *mathematical reserves* and the deposits received from *reinsurers* as shown in **Form 14**, together with any amount specified at line 63 of **Form 14** (being part of the excess of the value of the *admissible assets* representing the *long-term insurance funds* over the amount of those funds shown in **Form 14**), constitute proper provision at the end of the *financial year in question* for the *long-term insurance business liabilities* (including all liabilities arising from *deposit back arrangements*, but excluding other liabilities which had fallen due before the end of the *financial year*) including any increase in those liabilities arising from a distribution of surplus as a result of an *actuarial investigation* as at that date into the financial condition of the *long-term insurance business*, assessed in accordance with *PRU* in the context of assets valued in accordance with the *Valuation of Assets Rules*, as shown in **Form 13**;

(c) the *with-profits fund* has been managed in accordance with the *Principles and Practice of Financial Management*, as established, maintained and recorded under *COB 6.10*; and

(d) the *directors* have, in preparing the *return*, taken and paid due regard to-

(i) advice in preparing the return from every *actuary* appointed by the *insurer* to perform the *actuarial function* in accordance with *SUP 4.3.13R*; and

(ii) if applicable, advice from every *actuary* appointed by the *insurer* to perform the *with-profits actuary function* in accordance with *SUP 4.3.16R*.

3. (1) Where, in the opinion of those signing the certificate, the circumstances are such that any of the statements required by 1 and 2 cannot truthfully be made, the relevant statements must be omitted.
- (2) Where, by virtue of (1), any statements have been omitted from the certificate, this fact must be stated in a note to the certificate.

Part ~~III~~ II

Auditor's report

4. The report required by rule 9.35 must, in addition to any statement required under rule 9.35, state:

- (a) whether, in the auditor's opinion;
- (i) the documents referred to in rules 9.12, 9.13 and 9.14, together with Forms 40 to 45, 48, 49, 56, 58 and 60 and the statements, analyses and reports annexed pursuant to rules 9.24 to 9.27, 9.29 and 9.31 have been properly prepared in accordance with the *Accounts and Statements Rules* and *PRU*; and
- (ii) the methods and assumptions determined by the *insurer* and used to perform the *actuarial investigation* (as set out in the valuation reports) appropriately reflect the requirements of *PRU* 7.3 and 7.4.
- (b) that, in accordance with rule 9.35(1A), to the extent that any document, Form, statement, analysis or report to be audited under rule 9.35(1) contains amounts or information abstracted from the *actuarial investigation* performed pursuant to rule 9.4, the auditor has obtained and paid due regard to advice from a suitably qualified *actuary* who is independent of the *insurer*.

- ~~12.5.~~ Where the auditor refers in the report or in any note attached to it to any uncertainty, the report must state whether, in the auditor's opinion, that uncertainty is material to determining whether the *insurer* has available assets in excess of its ~~*required minimum margin, required EEA minimum margin or required UK minimum margin, as the case may be.*~~ *capital resources requirement.*

With-profits insurance capital component for the fund

Name of insurer	
With-profits fund	
Financial year ended	
Units	

	As at end of this financial year	As at end of the previous year	Source
	1	2	

Regulatory excess capital

Regulatory value of assets	Long-term admissible assets of the fund	11			See instruction 2
	Implicit items allocated to the fund	12			
	Mathematical reserves in respect of non-profit insurance contracts written in the fund	13			
	Long-term admissible assets of the fund covering the long-term insurance capital requirement allocated in respect of non-profit insurance contracts written in the fund	14			
	Long-term admissible assets of the fund covering the resilience capital requirement allocated in respect of non-profit insurance contracts written in fund	15			
	Total (11+12-(13+14+15))	19			See instruction 3
Regulatory value of liabilities	Mathematical reserves (after distribution of surplus) in respect of the fund's with-profit insurance contracts	21			See instruction 4
	Regulatory current liabilities of the fund	22			
	Total (21+22)	29			See instruction 5
Long-term insurance capital requirement in respect of the fund's with-profits insurance contracts		31			See instruction 5
Resilience capital requirement in respect of the fund's with-profits insurance contracts		32			See instruction 5
Sum of regulatory value of liabilities, long-term insurance capital requirement and resilience capital requirement (29+31+32)		39			See instruction 6
Regulatory excess capital (19-39)		49			See instruction 7

Realistic excess capital

Realistic excess capital	51			See instruction 8
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Excess assets allocated to with-profits insurance business

Excess (deficiency) of assets allocated to with-profits insurance business in fund (49-51)	61			
Face amount of capital instruments attributed to the fund and included in capital resources (unstressed)	62			See instruction 9
Face amount of capital instruments attributed to the fund and included in capital resources (stressed)	63			See instruction 10
With-profits insurance capital component for fund (if 62 exceeds 63, greater of 61+62-63 and zero; else greater of 61 and zero)	64			See instruction 11

Instruction 2: The entries at lines 11, 12, 13, 14 and 15 must equal the values determined in accordance with PRU 7.4.23R

Instruction 3: The entry at line 19 must equal the value determined in accordance with PRU 7.4.22R(1)

Instruction 4: The entries at lines 21 and 22 must equal the values determined in accordance with PRU 7.4.27R

Instruction 5: The entries at lines 29, 31 and 32 must equal the values determined in accordance with PRU 7.4.22R(2)(a), (b) and (c) respectively

Instruction 6: The entry at line 39 must equal the value determined in accordance with PRU 7.4.22R(2)

Instruction 7: The entry at line 49 must equal the value determined in accordance with PRU 7.4.22R

Instruction 8: The entry at line 51 must equal the value at Form 19, Line 66

Instruction 9: The entry at line 62 must equal C, determined in accordance with PRU 7.4.7R(3)(a)

Instruction 10: The entry at line 63 must equal D, determined in accordance with PRU 7.4.7R(3)(b)

Instruction 11: The entry at line 64 must equal the contribution in respect of the fund to the aggregate value determined in accordance with PRU 7.4.7R(1)

Realistic balance sheet

Name of insurer	
With-profits fund	
Financial year ended	
Units	

	As at end of this financial year	As at end of the previous year	Source
	1	2	

Realistic value of assets available to the fund

Regulatory value of assets	11		See instruction 2
Implicit items allocated to the fund	12		See instruction 3
Value of shares in subsidiaries held in the fund (regulatory)	13		See instruction 4
Excess admissible assets	21		See instruction 5
Present value of future profits (or losses) on non-profit insurance contracts written in the fund	22		See instruction 6
Value of derivatives and quasi-derivatives not already reflected in lines 11 to 22	23		See instruction 6a
Value of shares in subsidiaries held in the fund (realistic)	24		See instruction 6b
Prepayments made from the fund	25		See instruction 6c
Realistic value of assets of fund (11+21+22+23+24+25-(12+13))	26		See instruction 7
Support arrangement assets	27		See instruction 7a
Assets available to the fund (26+27)	29		

Realistic value of liabilities of fund

With-profits benefits reserve	31		See instruction 8
Future policy related liabilities	Past miscellaneous surplus attributed to with-profits benefits reserve	32	See instruction 9
	Past miscellaneous deficit attributed to with-profits benefits reserve	33	
	Planned enhancements to with-profits benefits reserve	34	
	Planned deductions for the costs of guarantees, options and smoothing from with-profits benefits reserve	35	
	Planned deductions for other costs deemed chargeable to with-profits benefits reserve	36	
	Future costs of contractual guarantees (other than financial options)	41	
	Future costs of non-contractual commitments	42	
	Future costs of financial options	43	
	Future costs of smoothing (*)	44	
	Financing costs	45	
	Any other liabilities related to regulatory duty to treat customers fairly	46	
	Other long-term insurance liabilities	47	
	Total (32+34+41+42+43+44+45+46+47-(33+35+36))	49	See instruction 10
Realistic current liabilities of the fund	51		See instruction 11
Realistic value of liabilities of fund (31+49+51)	59		See instruction 12

Realistic excess capital and additional capital available

Value of relevant assets before applying the most adverse scenario other than present value of future profits arising from business outside with-profits funds	62		See instruction 13
Amount of present value of future profits (or losses) on long-term insurance contracts written outside the fund included in the value of relevant assets before applying most adverse scenario	63		See instruction 14
Value of relevant assets before applying the most adverse scenario (62+63)	64		See instruction 15
Risk capital margin for fund (62-59)	65		See instruction 16
Realistic excess capital for fund (26-(59+65))	66		See instruction 17
Realistic excess available capital for fund (29-(59+65))	67		
Working capital for fund (29-59)	68		
Working capital ratio for fund (68/29)	69		

(*) - possibly negative items

Other assets potentially available if required to the cover the fund's risk capital margin

Additional amount potentially available for inclusion in line 62	81		See instruction 19
Additional amount potentially available for inclusion in line 63	82		See instruction 20

Instruction 2: The entry at line 11 must equal the value at Form 18, Line 19

Instruction 3: The entry at line 12 must equal the value at Form 18, Line 12

Instruction 4: The entry at line 13 must be the amount determined in accordance with PRU 1.3 and excluded from the amount calculated in accordance with PRU 7.4.32R(1)(a)

Instruction 5: The entry at line 21 must be the amount of the fund's excess admissible assets, determined in accordance with PRU 7.4.32R(1)(b)

Instruction 6: The entry at line 22 must be the present value of future profits (or losses) on any *non-profit insurance contracts* written in the *with-profits fund*, determined in accordance with PRU 7.4.32R(1)(c)

Instruction 6a: The entry at line 23 must be the market value of any *derivative or quasi-derivative* determined in accordance with PRU 7.4.32R(1)(d)

Instruction 6b: The entry at line 24 must be the amount determined in accordance with PRU 7.4.32R(1)(e)

Instruction 6c: The entry at line 25 must be the amount determined in accordance with PRU 7.4.32R(1)(f)

Instruction 7: The entry at line 26 must be the amount determined in accordance with PRU 7.4.31R(1)

Instruction 7a: The entry at line 27 must be any other amount providing support to the fund under a support arrangement, included with the prior agreement of the FSA

Instruction 8: The entry at line 31 must be the amount determined in accordance with PRU 7.4.38R(1)

Instruction 9: The entries at lines 32, 33, 34, 35, 36, 41, 42, 43, 44, 45, 46 and 47 must be the amounts determined in accordance with PRU 7.4.135R(1) to PRU 7.4.135R(11)

The entry at line 32 is the (positive) amount determined in accordance with PRU 7.4.135R(1) if this represents a surplus

The entry at line 33 is the (positive) amount determined in accordance with PRU 7.4.135R(1) if this represents a deficit

The entries at lines 34, 35, 36, 41, 42, 43, 44 and 45 are the amounts determined in accordance with PRU 7.4.135R(2) to PRU 7.4.135R(9) respectively

The entries at lines 46 and 47 are the values determined in accordance with PRU 7.4.135R(10) and PRU 7.4.135R(11)

Instruction 10: The entry at line 49 must be the amount determined in accordance with PRU 7.4.38R(2)

Instruction 11: The entry at line 51 must be the amount determined in accordance with PRU 7.4.38R(3)

Instruction 12: The entry at line 59 must be the amount determined in accordance with PRU 7.4.31R(2)(a)

Instruction 13: The entry at line 62 must be the amount described as A and determined in accordance with PRU 7.4.41R(3)(a) adjusted to exclude any amount taken into consideration under PRU 7.4.43R(1)

Instruction 14: The entry at line 63 must be any amount taken into consideration under PRU 7.4.43R(2)(c) in determining the amount described as A in accordance with PRU 7.4.41R(3)(a)

Instruction 15: The entry at line 64 must be the amount described as A and determined in accordance with PRU 7.4.41R(3)(a)

Instruction 16: The entry at line 65 must be the amount determined in accordance with PRU 7.4.31R(2)(b)

Instruction 17: The entry at line 66 must be the amount determined in accordance with PRU 7.4.31R

Instruction 19: This must be an amount not exceeding the sum of the value of the net shareholder assets of the firm and the surplus assets of the firm's non-profit funds, to the extent not included at any form 19 line 27 or at any form 19 line 62 and to the extent not required to meet regulatory capital requirements in respect of any business written outside the fund

Instruction 20: This must be an amount not exceeding 50% of the present value of future profits arising from insurance contracts written by the firm outside its with-profits funds reduced by the sum of any amounts included at any form 19 line 63

APPENDIX 9.4A (rule 9.31(b))

ABSTRACT OF VALUATION REPORT FOR REALISTIC VALUATION

The following information must be provided in the abstract of the report required under rule 9.31(b), the answers being numbered to accord with the numbers of the corresponding paragraphs of this Appendix. For the purposes of this Appendix, the “report period” means the period from the date to which the previous calculation of the *with-profits insurance capital component* under rule 9.4(2)(c) related to the ‘valuation date’ (as defined in 1).

Introduction

1. (1) The date to which the actuarial investigation relates, namely, the **valuation date**.
- (2) The date of the previous valuation.
- (3) The dates of any interim valuations carried out since the previous ‘valuation date’.

Assets

2. (1) For each *with-profits fund* in which any *non-profit insurance contracts* are written, a table of the economic assumptions used to determine the value of future profits (or losses) on those contracts, showing the economic assumptions used at the end of the *financial year in question*, and used at the end of the *preceding financial year*.
- (2) For each *with-profits fund* in respect of which the *realistic value of the assets* includes an amount determined under *PRU 7.4.32R(2)*, a table of the economic assumptions used to determine any additional amount by reference to the value of future profits (or losses) on *non-profit insurance contracts* according to *PRU 7.4.32R(3)(b)(iii)*.
- (3) For each *with-profits fund* in respect of which an asset not exceeding 50 % of the present value of future profits arising from insurance contracts written outside the *with-profits funds* is included in the relevant assets for the purpose of *PRU 7.4.41R* in accordance with *PRU 7.4.43R(2)(c)*, a table of the economic assumptions used to determine that present value.

- (4) Where the valuation of the future profits (or losses) on *non-profit insurance contracts* in (1) or of any additional amount in (2) or of any present value in (3) involves more than one set of economic assumptions, (for example, different sets of economic assumptions are used for different *with-profits funds*), each different set of economic assumptions must be shown.
- (5) The separate disclosure of economic assumptions used to determine the valuation of future profits (or losses) on *non-profit insurance contracts* in (1) or of any additional amount in (2) or of any present value in (3) is not required to the extent the total of the values derived by reference to assumptions which are not disclosed is less than £20 million.

With-Profits Benefits Reserve Liabilities

- 3. (1) For each *with-profits fund*, a table of the retrospective methods (see *PRU 7.4.116R*) and/or prospective methods (see *PRU 7.4.126R*) used to calculate the *with-profits benefits reserve* for that fund, showing:
 - (a) the types of product or classes of *with-profits insurance contracts* to which each of the retrospective methods and/or prospective methods applies;
 - (b) for each type of product or class of *with-profits insurance contracts* and method, the corresponding amounts of the *with-profits benefits reserve* and the *future policy related liabilities*; and
 - (c) the aggregate amount of the *with-profits benefits reserve* and the *future policy related liabilities* for those types of product or classes of *with-profits insurance contracts* which are not required to be disclosed separately (in accordance with 3(3)).
- (2) If the total of the amounts of the *with-profits benefits reserve* and *future policy related liabilities* shown in the table under (1) do not correspond to the respective amounts shown at lines 31 and 49 of the appropriate **Form 19**, an explanation and reconciliation must be provided.
- (3) The separate disclosure of the retrospective methods and prospective methods used to calculate the *with-profits benefits reserve* of a *with-profits fund* is not required for types of products and/or classes of *with-profits insurance contracts* to the extent the aggregate amount of the *realistic value of liabilities* for all types of products and/or classes of *with-profits insurance contracts* in respect of which the valuation methods are not disclosed is less than the higher of 5% of the *realistic value of liabilities* for that fund and £20 million. References to types of product and/or classes should be taken as meaning the

constituent elements of a division of the portfolio of *with-profits insurance contracts* by grouping those contracts having regard to materially different guarantees and options such as *pension contracts* with minimum bonuses and annuity rate options, *pension contracts* with minimum bonuses, *pension contracts* with no minimum bonuses, life bonds issued with no Market Value Reduction / Market Value Adjustment type clauses (MVR/MVAs), life bonds with spot MVR/MVA free dates (dates on which the MVR/MVAs do not apply), life bonds with no MVR/MVA free dates, etc.. The extent of disclosure should be sufficient to permit an identification of material groupings of contracts which offer significant variance in terms of the nature of benefits provided to *policyholders*.

With-profits benefits reserve – Retrospective method

4. (1) For each *with-profits fund*, a table of the retrospective methods used to calculate the *with-profits benefits reserve* showing for each retrospective method:
 - (a) the proportion of the *with-profits benefit reserve* calculated using that retrospective method for which contracts have been valued on an individual basis;
 - (b) the proportion of the *with-profits benefit reserve* calculated using that retrospective method for which contracts have been valued on a grouped basis; and
 - (c) in relation to any *with-profits insurance contracts* that have been grouped:
 - i) a statement of the basis used to group contracts;
 - ii) the number of individual contracts and the number of model points used to represent them; and
 - iii) the nature of the validations made to ensure that significant attributes of the contract groupings have not been lost.
- (2) For each *with-profits fund*:
 - (a) a description of any significant changes to the valuation method for any types of product or classes of *with-profits insurance contracts* written in that fund compared to the previous valuation; and

- (b) where the changes in (a) have resulted in any types of product or classes of *with-profits insurance contracts* written in that fund being valued using approaches more approximate than used for the previous valuation, a statement of the types of product or classes of *with-profits insurance contracts* affected.
- (3) For each *with-profits fund*, a description of the basis of allocating expenses to that fund during the *financial year in question* identifying:
 - (a) the date of the previous expense investigation;
 - (b) the frequency of expense investigations;
 - (c) a table of the total expenses allocated to the *with-profits benefits reserve* during the *financial year in question* showing:
 - (i) the nature and amount of expenses identified as initial expenses;
 - (ii) the nature and amount of expenses identified as maintenance expenses;
 - (iii) how expenses are charged to the *with-profits benefits reserve* in respect of individual contracts (for example, by way of an average expense charge deducted from all contracts); and
 - (iv) the nature and amount of any expenses charged other than to the *with-profits benefits reserve*.
- (4) For each *with-profits fund*, a description of the nature and amount of any significant charges (for example for the costs of guarantees or the use of capital) deducted from the *with-profits benefits reserve* during the *financial year in question* and a comparison to the charges in the *preceding financial year*.
- (5) For each *with-profits fund*, a description of the nature and amount of any charges deducted from that fund for non-insurance risk (for example, charges deducted from investment only accumulating with-profit business).
- (6) For each *with-profits fund*, a statement of the average ratio (expressed as a percentage) over the preceding three *financial years* of:

- (a) the *claims* paid on *with-profits insurance contracts* written in that fund;
to
- (b) the result of the:
 - (i) *with-profits benefits reserve* for those *claims* (as shown at line 31 of the appropriate **Form 19**); plus
 - (ii) any past miscellaneous surplus attributed to the *with-profits benefits reserve* in respect of those *claims* (as shown at line 32 of the appropriate **Form 19**); less
 - (iii) any past miscellaneous deficit attributed to the *with-profits benefits reserve* in respect of those *claims* (as shown at line 33 of the appropriate **Form 19**);

at the end of the *financial year in question* and at the end of the *preceding financial year*.

Where there has been a change in procedures such that the ratio of (a) to (b) would not be directly comparable with that ratio disclosed at the end of the *preceding financial year*, details should be disclosed as to the change in procedures.

- (7) For each *with-profits fund*, the investment return before tax and expenses allocated to the *with-profits benefits reserve* in respect of the *financial year in question*. If the investment return allocated to the *with-profits benefits reserve* in respect of any types of product or classes of *with-profits insurance contracts* differs materially from that allocated to the *with-profits benefits reserve* in respect of other types of product or classes of *with-profits insurance contracts*, other than because of tax, an explanation and reconciliation must be provided.

With-profits benefits reserve – Prospective method

- 5. (1) For each *with-profits fund*, a table of the key assumptions used in the prospective method(s) of calculating the *with-profits benefits reserve* showing:
 - (a) the risk discount rate as per the table in 6(4)(a)(iii) below;

- (b) the investment returns and risk adjustments made to assets (categorised as **Form 48**);
 - (c) expense inflation;
 - (d) future assumed annual and final bonus rates for major types of products and/or classes of *with-profits insurance contracts*;
 - (e) assumptions as to future expenses and future charges for expenses for major types of products and/or classes of *with-profits insurance contracts*; and
 - (f) any significant persistency assumptions at quinquennial durations.
- (2) Where any of the prospective methods in (1) involves more than one set of key assumptions, each different set of key assumptions must be shown.

Costs of guarantees, options and smoothing

6. (1) For each *with-profits fund*, where the costs of guarantees, options and smoothing do not exceed the lesser of £50m and 0.5% of the total *realistic value of liabilities*, disclosure of the valuation methods in accordance with the following sub-paragraphs is not required.
- (2) For each *with-profits fund*, a table of the valuation methods used to calculate the costs of guarantees, options and smoothing showing:
- (a) the types of product and/or classes of *with-profits insurance contracts* to which each valuation method applies;
 - (b) for each valuation method and each type of product and/or class of *with-profits insurance contract*:
 - (i) the proportion of the *with-profits insurance contracts* being valued for which costs have been valued on an individual basis;
 - (ii) the proportion of the *with-profits insurance contracts* being valued for which costs have been valued on a grouped basis; and

- (iii) in relation to any *with-profits insurance contracts* that have been grouped,
- a statement of the basis used to group contracts;
 - the number of individual contracts and the number of model points used to represent them;
 - the nature of the validations made to ensure that significant attributes of the contract groupings have not been lost.
- (c) if applicable to the disclosures in (a) and (b), a description of any significant approximations in method used for any residual types of product or classes of *with-profits insurance contracts*.
- (3) A description of any significant changes to the valuation methods for valuing the costs of guarantees, options or smoothing since the previous valuation.
- (4) For each of the valuation methods under (2)(b), the following information must be disclosed:
- (a) for each of the costs of guarantees, options and smoothing which have been valued using a full stochastic approach:
- (i) the nature of the guarantee, option or smoothing being valued, including a description of the extent to which the guarantee or option is in or out of the money at the valuation date;
 - (ii) a description of the nature of the asset model(s), including the choice of parameters for each model (including the assumed volatility of assets both short term and long term) and any assumed correlations between asset classes and/or between asset classes and economic indicators (such as inflation), and a justification for these assumptions;
 - (iii) completion of the following table showing the annualised compound equivalent of the risk free rate(s) assumed for each duration (n) and values derived from the asset model(s) of specified assets/options as shown in the table:

		Asset type (all UK assets)	K=0.75				K=1				K=1.5			
	n		5	15	25	35	5	15	25	35	5	15	25	35
	r	Annualised compound equivalent of the risk free rate assumed for the period. (to two decimal					x	x	x	x	x	x	x	x

		places)												
1		Risk-free zero coupon bond					x	x	x	x	x	x	x	x
2		FTSE All Share Index (p=1)												
3		FTSE All Share Index (p=0.8)												
4		Property (p=1)												
5		Property (p=0.8)												
6		15 year risk free zero coupon bonds (p=1)												
7		15 year risk free zero coupon bonds (p=0.8)												
8		15 year corporate bonds (p=1)												
9		15 year corporate bonds (p=0.8)												
10		Portfolio of 65% FTSE All Share and 35% property (p=1)												
11		Portfolio of 65% FTSE All Share and 35% property (p=0.8)												
12		Portfolio of 65% equity and 35% 15 risk free zero coupon bonds (p=1)												
13		Portfolio of 65% equity and 35% 15 risk free zero coupon bonds (p=0.8)												
14		Portfolio of 40% equity, 15% property, 22.5% 15 year risk free zero coupon bonds and 22.5% 15 year corporate bonds (p=1)												
15		Portfolio of 40% equity, 15% property, 22.5% 15 year risk free zero coupon bonds and 22.5% 15 year corporate bonds (p=0.8)												
			L=15			L=20			L=25					
16		Receiver swaptions												

Row 1 should be completed showing the value of cash payments of £1,000,000 due n years after the valuation date.

Rows 2 to 15 inclusive should be completed for the appropriate asset classes showing the value of a put option on a portfolio worth £1,000,000 on the valuation date exercisable n years after the valuation date with strike price of $K \times £1,000,000 \times (1+r \times p)^n$.

All references to 15 year bonds mean rolling bonds traded to maintain the 15 year duration at all future dates.

The corporate bonds should be assumed to be rolling AA rated zero coupon bonds.

Row 16 should be completed showing the value of sterling receiver swaptions with a strike of 5% exercisable n years after the valuation date with swap durations on exercise of L years. The values should be expressed as a percentage of nominal.

The property put options should be assumed to relate to a well diversified portfolio of UK commercial property.

A zero trend growth in property prices should be assumed where this is relevant.

In each case the options should be valued with reinvestment of any dividend income into the FTSE All Share index and reinvestment of any rental or other property income into UK property.

Tax should be ignored in all calculations.

All options should be assumed to be European-style.

- (iv) a statement of the initial equity and property rental yields assumed for the UK and each significant territory as applicable;
 - (v) for each significant territory other than the UK a statement of the entries that would be appropriate (for K=1 only) for the risk free rate and lines 1 and 2;
 - (vi) a table showing the outstanding durations of significant guarantees within material types of products and/or classes of *with-profits insurance contracts* together with the details of the fit of the asset model(s) to specimen relevant market traded instruments at these durations;
 - (vii) a statement of the nature of the validations of the asset model(s) by projecting future income, gains and losses on asset values and comparing the net present value of these amounts to the current asset values;
 - (viii) a statement of the number of projections of assets and liabilities carried out and the nature of the validations to ensure reasonable convergence of the model results;
- (b) for each of the costs of guarantees, options and smoothing which have been valued using the market costs of hedging:
- (i) a description of the method and assumptions used to determine the option points and amounts implied by the underlying guarantee or option or smoothing;
 - (ii) a description of the method and assumptions used to value the implied options and hence to determine the costs of the underlying guarantee, option or smoothing (including the assumed volatility of assets both short term and long term and any assumed correlations between asset classes and/or between asset classes and economic indicators (such as inflation) and also including a description as to how those assumptions relate to available market traded instruments and have been assumed to apply in respect of non-available instruments);
 - (iii) completion of a table as 6(4)(a)(iii) above showing the risk free rate(s) assumed and values derived from the asset model(s) of assets/options as shown in the table;

- (iv) a statement of the equity and property rental yields assumed for the UK and each significant territory as applicable;
 - (v) a table showing the outstanding durations of significant guarantees within material types of products and/or classes of *with-profits insurance contracts*;
- (c) for each of the costs of guarantees, options and smoothing which have been valued using a series of deterministic projections using attributed probabilities:
 - (i) a description of the number of projections of assets and liabilities carried out, the attributed probability to each projection and the range of key assumptions underlying the projections of assets and liabilities;
 - (ii) a description of how the range of projections was selected and how the attributed probabilities were determined;
 - (iii) completion of a table as 6(4)(a)(iii) above showing the risk free rate(s) assumed and values derived from the asset model(s) of assets/options as shown in the table;
 - (iv) a table showing the outstanding durations of significant guarantees within material types of products and/or classes of *with-profits insurance contracts*.
- (5) Where management actions have been assumed in the projection of assets and liabilities used to determine the costs in (4) (a), (b) and (c):
 - (a) a description of the nature of the management actions assumed in the projection of assets and liabilities; and
 - (b) a table of the *firm's* best estimates as to the future proportions of the assets backing the *with-profits benefits reserve* which would consist of equities (whether UK or non UK) and as to future bonus rates, in each case as at the end of the *financial year in question*, in 5 years time and in 10 years time, making the three sets of assumptions described in this paragraph as to annual investment returns over the periods in question. The table must show, in addition to the specimen equity backing ratios (for the fund), annual bonus rates on significant accumulating with-profits business (for each of life and pensions business separately). Calculations should be made assuming that the annual investment return on all assets over the period in question is (i) based on forward

rates derived from the risk free interest rate curve as calibrated at the valuation date (ii) based on forward rates derived from the risk free interest rate curve increased across the period by 17.5 % of the long-term gilt yield and (iii) based on forward rates derived from the risk free interest rate curve reduced across the period by 17.5 % of the long-term gilt yield. The effect of any significant assumed equity *derivative contracts* or contracts having the effect of *derivative contracts* on the values disclosed in the table should be described by note. The long-term gilt yield is as described in *PRU 7.4.11R*.

- (6) For material types of product or classes (as identified in 3 above) a statement of the persistency assumptions used to determine the costs in (4) (a), (b) and (c), and where appropriate the assumed take-up rates of guaranteed annuity options and the rates of annuitant mortality assumed.
- (7) A statement of the assumptions made, regarding the foreseeable actions that would be taken by *policyholders*, in the projection of assets and liabilities in (4) (a), (b) and (c).

Financing costs

- 7. Where financing arrangements exist in connection with any *with-profits fund(s)*, a statement of the type of financing, the sources available for repayment of capital and interest, the extent to which repayments are subordinated to *policyholders'* interests, the face amount outstanding, the rate of interest payable, the level of fees payable, the expected amount to be repaid and the expected time period for such repayment (or, in the case of reinsurance arrangements, recapture).

Other long-term insurance liabilities

- 8. For each *with-profits fund*, a statement of the nature and amount of *long-term insurance liabilities* which have been included within the amounts of 'any other liabilities related to regulatory duty to treat customers fairly' and 'any other long-term insurance liabilities' shown at lines 46 and 47 of **Form 19**, including disclosure of any value attributed to future tax relief.

Realistic current liabilities

- 9. A statement of the nature and amount of current liabilities which have been included within the amount of the *realistic current liabilities* shown at line 51 of **Form 19** together with a reconciliation to the amount of the *regulatory current liabilities*.

Risk capital margin

10. For the calculation of the *risk capital margin* for each *with-profits fund*:

- (a) a statement of the amount of the *risk capital margin* and of information relating to the individual scenarios in *PRU 7.4.42R* which comprise the most adverse scenario for the purposes of calculating that margin according to *PRU 7.4.41R*, including:
 - (i) the percentage change assumed in accordance with *PRU 7.4.65R* for each of the market values of equities and real estate for the purpose of the *market risk* scenario for UK assets and each significant territory in *PRU 7.4.60R(1)(a)*, and a statement as to whether a rise or fall was the most onerous in each case;
 - (ii) the nominal change in yields assumed in accordance with *PRU 7.4.65R* for fixed interest securities for the purpose of the *market risk* scenario for UK assets and each significant territory in *PRU 7.4.60R(1)(a)* together with a statement of the percentage change in and level of the long term gilt yield or nearest equivalent assumed in each case and a statement as to whether a fall or rise in yields is the more onerous in each case);
 - (iii) the average change in spread for bonds (weighted by value) and the total percentage change in asset value separately for (a) bonds, (b) debts, (c) reinsurance (d) analogous non-reinsurance financing agreements and (e) other assets (by reference to *PRU 7.4.75R*), where the total percentage change is, in each case, calculated as the overall percentage change that results from applying the *credit risk* scenario to the actual assets of each type held by a *firm*;
 - (iv) the average change in persistency experience (weighted by *realistic value of liabilities*) expressed as an annual percentage and the overall percentage change in the *realistic value of liabilities* that results from applying the persistency risk scenario according to *PRU 7.4.97R*; and
 - (v) to the extent any change in asset value in (iii) is not materially independent of the change in liability values in (iv), a

description of the approach to deriving the disclosed changes in asset and liability values;

- (b) a statement of the nature of any management actions assumed in the *risk capital margin* calculation that are in addition to those set out in 6(5)(a) above; and any material changes to other assumptions;
- (c)
 - (i) a statement of the nature of the assets (categorised as **Form 48**) and location of assets held to cover the *risk capital margin*;
 - (ii) if any of the assets to cover the *risk capital margin* are located outside of the *with-profits fund* a statement as to the way the *firm* would intend to make such assets available to the *with-profits fund* should the need arise.

Tax

- 11. A statement of the *firm's* treatment of tax included on assets backing (i) the *with-profits benefits reserve(s)*, (ii) any *future policy related liabilities* and (iii) any *realistic current liabilities*, including any simplifying assumptions.

Derivatives

- 12. A full description of any major positions in relation to *derivative contracts* or contracts having the effect of *derivative contracts* held by the *with-profits fund* or located outside the *with-profits fund* to cover the *risk capital margin* in part or in full at the valuation date.

Analysis of working capital

- 13. For each *with-profits fund*, a reconciliation of the significant movements in the working capital of the *with-profits fund* from that shown at line 67 of **Form 19** at the end of the *preceding financial year* and that same entry shown for the *financial year in question*. Such movements should at least include investment return, tax, significant costs (of expenses, guarantees or smoothing) and enhancements or charges to *retrospective reserve(s)*.

Optional disclosure

- 14. At the option of the firm, a statement may be made for each *with-profits fund* of the amount of the *realistic value of liabilities* which relates to contractual

obligations to policyholders, with a description of the approach taken to distinguishing contractual and non-contractual obligations to policyholders.

Instructions to the report

Adhere to numbering above, enter 'not applicable' or 'de minimis' for sections where there is nil or de minimis data.

SUPERVISION MANUAL (SUP)

Chapter 4: Actuaries

4.3 Appointment of actuaries

Appointment by firms

4.3.1R A *firm* to which this section applies (see *SUP* 4.1) must:

- (1) appoint **one or more actuaries** (the "**appointed actuary**") to perform:
 - (a) the **actuarial function** (see *SUP* 4.3.13R) in respect of all classes of its **long-term insurance business**; and
 - (b) the **with-profits actuary function** (see *SUP* 4.3.16R) in respect of all classes of its **with-profits business** (if any);
- (2) **notify the FSA, without delay, when it is aware that a vacancy in the office of any such appointed actuary will arise or has arisen, giving the reason for the vacancy;**
- (3) **appoint an *actuary* to fill any such vacancy ~~in the office of appointed actuary~~ that has arisen; and**
- (4) **ensure ~~the~~ a replacement *actuary* can take up office at the time the vacancy arises or as soon as reasonably practicable after that.**

4.3.2G The provisions relating to the duties of an ~~the appointed actuary~~ who has been appointed to perform this ~~these~~ functions are set out in *SUP* 4.3.13R to *SUP* 4.3.24G. The functions performed by actuaries appointed ~~Acting in the capacity of appointed actuary of~~ by a firm under *SUP* 4.3.1R ~~is~~ are specified as a controlled functions (CF 12, the ~~appointed actuarial~~ function, and CF 12A, the with-profits actuary function) in *SUP* 10 (*Approved persons*). As a result, an application must be made to the *FSA* under section 60 of the *Act* (Applications for approval) for approval of the *person* proposing to take up such an appointment ~~as an appointed actuary~~. Section 61(3) of the *Act* (Determination of applications) gives the *FSA* three months to grant its approval or give a *warning notice* that it proposes to refuse the application. A *firm* should not appoint an *actuary* until the *FSA* has approved the *actuary*. In order to comply with *SUP* 4.3.1R, a *firm* should ensure it applies to the *FSA* as soon as practicable before the date when it needs the *actuary* to take office. The *FSA* will need time to consider the application before deciding whether to grant approval. See *SUP* 10 (*Approved persons*).

Appointment by the FSA

4.3.3R If a *firm*, which is required to appoint one or more actuaries ~~an actuary~~ under *SUP* 4.3.1R, fails to do so within 28 days of a vacancy arising, the *FSA* may appoint one or more actuaries ~~an actuary~~ to perform any

function corresponding to the *actuarial function* or the *with-profits actuarial function*~~the function of *appointed-actuary*~~ on the following terms:

- (1) the *actuary* to be remunerated by the *firm* on the basis agreed between the *actuary* and the *firm* or, in the absence of agreement, on a reasonable basis; and
- (2) the *actuary* to hold office until he resigns or the *firm* appoints another *actuary*.

4.3.4G *SUP 4.3.3R* allows but does not require the *FSA* to appoint an *actuary* if the *firm* has failed to do so within the 28 day period. When it considers whether to use this power, the *FSA* will take into account the likely delay until the *firm* can make an appointment and the urgency of any pending duties of the ~~*appointed*~~ *actuary*.

4.3.5G The *FSA* will not normally seek to appoint an *actuary* under *SUP 4.3.3R* if a notification under *SUP 10 (Approved persons)* has been received from the *firm* in relation to a proposed appointment of an *actuary* under *SUP 4.3.1R*, and that application is still being considered.

4.3.6R A *firm* must comply with and is bound by the terms on which an *actuary* has been appointed by the *FSA* under *SUP 4.3.3R*.

4.3.7G If the *FSA* appoints an *actuary* under *SUP 4.3.3R*, he will not be an ~~*appointed-actuary*~~ *approved person* (not being appointed under *SUP 4.3.1R*)~~and will not therefore need to be an *approved person*~~. However, the *firm* is still under an obligation to appoint an *actuary* under *SUP 4.3.1R* and will need to seek prior approval of that *person* (even if the individual it proposes to appoint is the *person* who has been appointed by the *FSA* under *SUP 4.3.3R*).

~~Appointed-actuary's~~ Actuaries' qualifications

4.3.8G The *FSA* is concerned to ensure ~~that every~~ the *appointed-actuary* appointed by a *firm* under this section has the necessary skill and experience to provide the *firm* with appropriate actuarial advice. *SUP 4.3.9R* to *SUP 4.3.10G* set out the *FSA's* *rules* and *guidance* aimed at achieving this.

4.3.9R Before a *firm* applies for approval of its proposed appointment of an *appointed-actuary* under *SUP 4.3.1R*, it must take reasonable steps to ensure that the *actuary*:

- (1) has the required skill and experience to perform his functions under the *regulatory system*; and
- (2) is a Fellow of the Institute of Actuaries or of the Faculty of Actuaries.

4.3.10G To comply with *SUP 4.3.9R* and *Principle 3*, before an ~~*appointed*~~ *actuary* takes up his appointment, the *firm* should ensure that the *actuary*:

- (1) has skills and experience appropriate to the nature, scale and complexity of the *firm's* business and the requirements and standards under the *regulatory system* to which it is subject; and
- (2) has adequate qualifications and experience, which includes holding an appropriate Appointed Actuaries Practising Certificate under the rules of the Institute of Actuaries or the Faculty of Actuaries;

and seek confirmation of these from the *actuary*, or the *actuary's* current and previous employers, as appropriate.

Disqualified actuaries

4.3.11R ***A firm must not appoint under SUP 4.3.1R as ~~appointed~~ actuary an actuary who is disqualified by the FSA under section 345 of the Act (Disqualification) from acting as an actuary either for that firm or for a relevant class of firm.***

4.3.12G If it appears to the *FSA* that an ~~appointed~~ *actuary* has failed to comply with a duty imposed on him under the *Act*, it may disqualify him under section 345 of the *Act*. For more detail about what happens when the disqualification of an *actuary* is being considered or put into effect, see *ENF 17 (Disqualification of auditors and actuaries)*. A list of *actuaries* who are disqualified by the *FSA* may be found on the *FSA* website (www.fsa.gov.uk).

Conflicts of interest

4.3.12AR ***A firm must take reasonable steps to ensure that an actuary who is to be, or has been, appointed under SUP 4.3.1R:***

- (1) does not perform the function of chairman or chief executive of the firm, or, if he is to perform the with-profits actuary function, become a member of the firm's governing body; and**
- (2) does not perform any other function on behalf of the firm which could give rise to a significant conflict of interest.**

4.3.12BG Both the *actuarial function* and the *with-profits actuary function* may be performed by *employees* of the *firm* or by external consultants, and performing other functions on behalf of the *firm* will not necessarily give rise to a significant conflict of interest. However, being a *director*, or a senior manager responsible, say, for sales or marketing in a *firm* (or for finance in a *proprietary firm*), is likely to give rise to a significant conflict of interest for an *actuary* performing the *with-profits actuary function*. He nevertheless retains direct access to the *firm's governing body* under SUP 4.3.20R(2).

The actuarial function ~~**Rights and duties of the appointed actuary**~~

4.3.13R ***An appointed actuary who has been appointed to perform the actuarial function must, in respect of those classes of the firm's long-term insurance business which are covered by his appointment:***

- (1) ~~identify and monitor~~ advise the *firm*'s management, at the level of seniority that is reasonably appropriate, on the risks the *firm* runs in so far as they may have a material impact on the *firm*'s ability to meet *liabilities* to *policyholders* in respect of *long-term insurance contracts* as they fall due and on the capital needed to support the business, including regulatory capital requirements;
- (2) monitor those risks and inform the *firm*'s management, at the level of seniority that is reasonably appropriate, if he has any material concerns or good reason to believe that the *firm*:
 - (a) is not meeting *liabilities* to *policyholders* under *long-term insurance contracts* as they fall due, or may not be doing so, or might not have done so, or might, in reasonably foreseeable circumstances, not do so;
 - (b) is, or may be, effecting new *long-term insurance contracts* ~~on inadequate terms contrary to [IPRU(INS) 3.5A or IPRU(FSOC) 4.13] [number to be inserted later]~~ as applicable on terms under which the resulting income earned is insufficient, under reasonable actuarial methods and assumptions, and taking into account the other financial resources that are available for the purpose, to enable the *firm* to meet its *liabilities* to *policyholders* as they fall due (including reasonable bonus expectations);
 - (c) does not, or may not, have sufficient financial resources to meet *liabilities* to *policyholders* as they fall due (including reasonable bonus expectations) and the capital needed to support the business, including regulatory capital requirements or, if the *firm* currently has sufficient resources, might, in reasonably foreseeable circumstances, not continue to have them;
- (3) advise the *firm*'s governing body on the methods and assumptions to be used for the investigations required by IPRU(INS) 9.4R or IPRU(FSOC) 5.1R and the calculation of the *with-profits insurance capital component* under PRU 7.4 as applicable;
- (4) perform those investigations and that calculation, in accordance with the methods and assumptions determined by the *firm*'s governing body;
- (5) report to the *firm*'s governing body on the results of those investigations and that calculation; and
- (6) in the case of a *friendly society* to which this section applies, perform the functions of the appropriate actuary under section 87 (Actuary's report as to margin of solvency) of the Friendly Societies Act 1992.

- ~~(3) — perform actuarial investigations and prepare abstracts of those investigations as required by *IPRU(INS)* 9.4R or *IPRU(FSOC)* 5.1R as applicable;~~
- ~~(4) — request from the *firm* such information and explanations as are reasonably considered necessary to enable him to properly perform the duties described in *SUP* 4.3.13R(1) to (3); and~~
- ~~(5) — advise the *firm* as to the data and systems reasonably needing to be kept and maintained to provide such information and explanations.~~

4.3.14G *IPRU(INS)* 9.4R and *IPRU(FSOC)* 5.1R require *firms* to which this section applies to cause an investigation to be made at least yearly by the *actuary* or *actuaries* appointed to perform the *actuarial function*, and to report on the result of that investigation. *PRU* 7.4 requires *realistic basis life firms* to calculate the *with-profits insurance component* as part of their capital resources requirements. The *firm* is responsible for the methods and assumptions used to determine the *liabilities* attributable to its *long-term insurance business*. The obligation on *friendly societies* to obtain a report from the ‘appropriate actuary’ under section 87 of the Friendly Societies Act 1992 applies to a *friendly society* which is to receive a transfer of engagements under section 86 (transfer of engagements to or by a friendly society). The ‘appropriate actuary’ in this context is the *actuary* appointed to perform the *actuarial function*, rather than the *appropriate actuary* under *SUP* 4.4 (Appropriate actuaries). A *liability to a policyholder* is defined in the *Glossary* as any liability or obligation of an *insurer* to, or in respect of, a *policyholder*. It includes *policyholder’s* reasonable expectations as to discretionary benefits and charges.

4.3.15G *SUP* 4.3.13R is not intended to be exhaustive of the professional advice that a *firm* will wish to take whether from an *actuary* appointed under this chapter or from any other *actuary* acting for the *firm*. *Firms* will want to consider what systems and controls are needed to ensure that they obtain appropriate professional advice on financial and risk analysis; for example:

- (1) risk identification, quantification and monitoring;
- (2) stress and scenario testing;
- (3) ongoing financial condition;
- (4) financial projections for business planning;
- (5) investment strategy and asset-liability matching;
- (6) individual capital assessment;
- (7) pricing of business, including unit pricing;
- (8) variation of any charges for benefits or expenses;

(9) discretionary surrender charges; and

(10) adequacy of reinsurance protection.

4.3.15G — ~~The *appointed* *actuary's* duty to request information does not necessarily require him to undertake continuous monitoring. This depends on the *firm's* size, financial position, future plans and other circumstances, including the robustness of its systems and controls. If a periodic update or review is sufficient, it should be carried out as often as is reasonably necessary. An annual update may suffice for small, financially sound, well-run *insurers*. Such periodic reviews might also usefully be supplemented by desk-based monitoring to identify circumstances where the timing of the next review might need to be brought forward.~~

4.3.16G — ~~If a *firm* also carries out general insurance contracts, the *appointed* *actuary* should consider the *general insurance business* to the extent, if any, that this might have an impact on the *long-term insurance business*.~~

The with-profits actuary function

4.3.16R An actuary who has been appointed to perform the *with-profits* actuary function must:

(1) advise the *firm's* *management*, at the level of seniority that is reasonably appropriate, on key aspects of the discretion to be exercised affecting those classes of the *with-profits* *business* of the *firm* in respect of which he has been appointed;

(1A) where the *firm* is a *realistic basis life* *firm* advise the *firm's* governing body as to whether the assumptions used to calculate the *with-profits* *insurance component* under PRU 7.4 are consistent with the *firm's* application of its *Principles and Practices of Financial Management* in respect of those classes of the *firm's* *with-profits* *business*;

(2) at least once a year, report to the *firm's* governing body on key aspects (including those aspects of the *firm's* application of its *Principles and Practices of Financial Management* on which ~~such~~ advice the advice described in (1) has been given) of the discretion exercised in respect of the period covered by his report affecting those classes of *with-profits* *business* of the *firm*;

(3) make a written report addressed to the relevant classes of the *firm's* *with-profits* *policyholders*, to accompany the *firm's* annual report under COB 6.11.9R, as to whether, in his opinion and based on the information and explanations provided to him by the *firm*, and taking into account where relevant the *rules* and *guidance* in COB 6.12, the annual ~~that~~ report and the discretion exercised by the *firm* in respect of the period covered by the report may be regarded as taking, or having taken, their interests into account in a reasonable and proportionate manner;

- (4) request from the *firm* such information and explanations as he reasonably considers necessary to enable him to properly perform the duties described in (1) to (3);
- (5) advise the *firm* as to the data and systems ~~reasonably needing that~~ he reasonably considers necessary to be kept and maintained to provide such information and explanations; and
- (6) in the case of a *friendly society* to which this section applies, perform the function of appropriate actuary under section 12 (Reinsurance) of the Friendly Societies Act 1992 or section 23A (Reinsurance) of the Friendly Societies Act 1974 as applicable, in respect of those classes of its *with-profits business* covered by his appointment.

4.3.17G In advising or reporting on the exercise of discretion, an *actuary* performing the *with-profits actuary function* would cover the implications for the fair treatment of the *firm's with-profits policyholders*. His opinion on any communication or report to them would also take into account their information needs and the extent to which the communication or report may be regarded as clear, fair and not misleading. Aspects of the business that would normally be included are:

- (1) bonus rates to be applied to *policies* at maturity or on the death of the *policyholder*, or as annual bonus;
- (2) investment policy in the light of product descriptions disclosed to *customers*;
- (3) surrender value methodology (including market value adjusters);
- (4) new business plans and premium rates;
- (5) allocation of expenses to *with-profits business*;
- (6) investment fees to be charged to *with-profits business*;
- (7) changes to the *Principles and Practices of Financial Management*; and
- (8) communication with *policyholders* or potential *policyholders* on the aspects listed above.

4.3.18G The extent of the report referred to in SUP 4.3.16(2) should be proportionate to the nature of the *with-profits business*. For smaller *firms* with fewer products, the extent of reporting would be proportionately less.

4.3.19G *Firms* should normally obtain advice, from the ~~relevant~~ *actuary* appointed to perform the *with-profits actuary function* in respect of the affected class or classes of *with-profits business*, whenever they are preparing to make key decisions based on the exercise of discretion affecting their *with-profits business*. *Firms* should also have risk management processes in place to ensure that all relevant matters are referred to the *actuary* for advice.

- 4.3.20R A *firm* must require and allow any its ~~appointed~~ *actuary* who has been appointed to perform the *with-profits actuary function* to perform his duties and, in particular:
- (1) keep him informed of the *firm's* business and other plans (including, where relevant, those of any related *firm*, to the extent it is aware of these);
 - (2) provide him with sufficient resources (including his own time and access to the time of others);
 - (3) hold such data and establish such systems as he reasonably requires;
 - (4) request his advice about the likely effect of material changes in the *firm's* business plans, practices or other circumstances on the fair treatment of *with-profits policyholders* ~~rights and reasonable expectations of policyholders in respect of long-term insurance contracts~~; and
 - (5) pay due regard to his advice, whether provided in response to a request under (4) or on the ~~appointed~~ *actuary's* own initiative; this will include, if he requests it, allowing him to present his advice directly to the *firm's governing body* (that is, the board of *directors* or, for a *friendly society*, the committee of management).
- 4.3.21G A *firm's* duty to keep ~~an its ~~appointed~~ *actuary* who has been appointed to perform the *with-profits actuary function*~~ informed includes providing relevant information, even where the ~~appointed~~ *actuary* does not ask for it. The *firm* needs to appreciate that the ~~appointed~~ *actuary* may be unaware of certain business developments and so unable to request relevant information.
- 4.3.22G ~~Section 341 of the *Act* (Access to books etc.) provides that an *appointed actuary who has been appointed under or as a result of the Act*:~~
- ~~(1) has a right of access at all times to the *firm's* books, accounts and vouchers; and~~
 - ~~(2) is entitled to require from the *firm's* officers such information and explanations as he reasonably considers necessary to perform his duties as *appointed actuary*.~~
- 4.3.23R ~~When carrying out his duties, an *appointed actuary appointed under SUP 4.3.1R* must pay due regard to generally accepted actuarial best practice.~~
- 4.3.24G The standards and guidance issued from time to time by the Institute of Actuaries and the Faculty of Actuaries are important sources of actuarial best practice.

Non-glossary definitions

The glossary text contains defined terms which were consulted on in CP204 and which will be implemented into the Handbook Glossary as part of that package. These definitions are reproduced here for the user's ease of reference prior to the inclusion of these definitions in the Handbook Glossary.

<i>accumulating with-profits policy</i>	a <i>with-profits insurance contract</i> which has a readily identifiable current benefit, whether or not this benefit is currently realisable, which is adjusted by an amount explicitly related to the amount of any premium payment and to which additional benefits are added in respect of participation in profits by additions directly related to the current benefit or a <i>policy</i> with similar characteristics.
<i>actuarial function</i>	controlled function CF12 in the table of controlled functions described more fully in SUP 4.3.13R and SUP 10.7.17R.
<i>actuarial health insurance</i>	(in <i>PRU</i>) (in the context of the <i>rules</i> in <i>PRU</i> 7.2 concerning the calculation of the <i>general insurance capital requirement</i>), health insurance which meets all the conditions set out in <i>PRU</i> 7.2.73R.
<i>actuarial investigation</i>	an investigation to which <i>IPRU(INS)</i> rule 9.4 applies.
<i>actuarial valuation date</i>	in <i>PRU</i> 7.3, the date as at which the <i>mathematical reserves</i> are calculated.
<i>administrative expenses</i>	has the meaning set out in the <i>insurance accounts rules</i> .
<i>admissible asset</i>	(in <i>PRU</i>) an asset that falls into one or more categories in <i>PRU</i> 2.2 Annex 1R.
<i>ancillary banking services undertaking</i>	<p>(as defined in article 1(23) of the <i>Banking Consolidation Directive</i> (Definitions) and in relation to any <i>undertaking</i> in a <i>consolidation group</i>, <i>sub-group</i> or another group of <i>persons</i>) an <i>undertaking</i> complying with the following conditions:</p> <p>(1) its principal activity consists in :</p> <ul style="list-style-type: none"> (a) owning or managing property; (b) managing data-processing services; or (c) any other similar activity; <p>(2) the activity in (1) is ancillary to the principal activity of one or more <i>credit institutions</i>;</p> <p>(3) those <i>credit institutions</i> are also members of that <i>consolidation group</i>, <i>sub-group</i> or group.</p>

<p><i>ancillary insurance services undertaking</i></p>	<p>(in relation to an <i>undertaking</i> in a <i>consolidation group</i>, <i>sub-group</i> or another group of <i>persons</i>) an <i>undertaking</i> complying with the following conditions:</p> <p>(1) its principal activity consists in :</p> <ul style="list-style-type: none"> (a) owning or managing property; (b) managing data-processing services; or (c) any other similar activity; <p>(2) the activity in (1) is ancillary to the principal activity of one or more <i>insurance undertakings</i>; and</p> <p>(3) those <i>insurance undertakings</i> are also members of that <i>insurance group</i>; and</p> <p>(4) (for the purpose of <i>PRU 8.4</i> (Cross sector groups), <i>PRU 8.5</i> (Third country groups), <i>PRU 8 Ann 1R</i> (Capital adequacy calculations for financial conglomerates) and <i>PRU 8 Ann 2R</i> (Prudential rules for third country groups) it is not an <i>ancillary banking services undertaking</i>.</p>
<p><i>ancillary investment services undertaking</i></p>	<p>(in relation to any <i>undertaking</i> in a <i>consolidation group</i>, <i>sub-group</i> or another group of <i>persons</i>) an <i>undertaking</i> complying with the following conditions:</p> <p>(1) its principal activity consists in :</p> <ul style="list-style-type: none"> (a) owning or managing property; (b) managing data-processing services; or (c) any other similar activity; <p>(2) the activity in (1) is ancillary to the principal activity of one or more <i>investment firms</i>;</p> <p>(3) those <i>investment firms</i> are also members of that <i>consolidation group</i>, <i>sub-group</i> or group.</p>

<i>ancillary risk</i>	<p>(a) in relation to an <i>insurer</i> with <i>permission</i> under the Act to insure a principal risk belonging to one <i>class</i> of <i>general insurance business</i>, means a risk included in another such <i>class</i> which is -</p> <ul style="list-style-type: none"> - connected with the principal risk, - concerned with the object which is covered against the principal risk, and - the subject of the same contract insuring the principal risk; <p>(b) but, the risks included in <i>classes</i> 14, 15 and 17 may not be treated as risks ancillary to other <i>classes</i>;</p> <p>(c) except the risk included in <i>class</i> 17 (legal expenses insurance) may be regarded as an ancillary risk of <i>class</i> 18 where the conditions laid down in (a) are fulfilled and where the principal risk relates solely to assistance provided for persons who fall into difficulties while travelling, while away from home or while away from their permanent residence or where it concerns disputes or risks arising out of, or in connection with, the use of sea-going vessels.</p>
<i>ancillary services undertaking</i>	an <i>ancillary insurance services undertaking</i> , an <i>ancillary banking services undertaking</i> or an <i>ancillary investment services undertaking</i> .
<i>Annual Accounts Directive</i>	the Council Directive of 19 December 1991 concerning the annual accounts and consolidated accounts of <i>insurance undertakings</i> (No 91/674/EEC).
<i>annual bonus</i>	(in relation to a <i>with-profits insurance contract</i>) a discretionary addition to policy benefits under a <i>with-profits insurance contract</i> made by a <i>long-term insurer</i> as a result of the annual <i>actuarial investigation</i> .
<i>annualised</i>	(for the purposes of <i>PRU 7.5</i>) the amount of any income or outgoing in a <i>financial year</i> , if the <i>financial year</i> is one year in duration; otherwise that amount multiplied by 365 and divided by the number of days in the firm's <i>financial year</i> .

<i>approved counterparty</i>	<p>any of the following –</p> <p>(a) an <i>approved credit institution</i>; or</p> <p>(b) a person permitted under the <i>Act</i> to conduct investment business of a kind which includes entering into <i>derivatives</i> which are not <i>listed</i> as principal; or</p> <p>(c) in respect of a transaction involving a new issue of <i>securities</i> which are to be <i>listed</i>, the <i>issuer</i> or an <i>ISD investment firm</i> acting on behalf of the issuer.</p>
<i>approved credit institution</i>	an institution recognised or permitted under the law of an <i>EEA State</i> to carry on any of the activities set out in Annex 1 to the <i>Banking Consolidation Directive</i> .
<i>approved derivative</i>	(in <i>PRU</i>) a <i>derivative</i> in respect of which the conditions in <i>PRU</i> 4.3.6R are met.
<i>approved financial institution</i>	<p>any of the following –</p> <ul style="list-style-type: none"> • the European Central Bank; • the central bank of an <i>EEA State</i>; • the International Bank for Reconstruction and Development; • the European Bank for Reconstruction and Development; • the International Finance Corporation; • the International Monetary Fund; • the Inter-American Development Bank; • the African Development Bank; • the Asian Development Bank; • the Caribbean Development Bank; • the European Investment Bank; • the European Community; and • the European Atomic Energy Community.
<i>approved quasi-derivative</i>	a <i>quasi-derivative</i> in respect of which the conditions in <i>PRU</i> 4.3.6R are met.

<i>approved security</i>	<p>(a) any <i>security</i> 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, which belongs to a <i>Zone A country</i>;</p> <p>(b) any loan to, or deposit with, an <i>approved financial institution</i>; and</p> <p>(c) any <i>debenture</i> issued before 31 December 1994 by the Agricultural Mortgage Corporation Limited or the Scottish Agricultural Securities Corporation Limited.</p>
<i>approved stock lending transaction</i>	a <i>stock lending</i> transaction in respect of which the conditions in <i>PRU 4.3.37R</i> have been met.
<i>assessable mutual</i>	(for the purposes of <i>PRU 7.5</i>) a <i>mutual</i> where the <i>insurance business</i> carried out by the <i>mutual</i> is limited to the provision of <i>insurance business</i> to its members and whose articles of association, rules or bye laws provide for the calling of additional contributions from members to meet <i>claims</i> .
<i>asset management company</i>	(for the purpose of <i>ELM</i> and <i>PRU 8</i> (Group risk) and in accordance with Article 2(5) of the <i>Financial Groups Directive</i> (Definitions)) a management company within the meaning of Article 1a(2) of the <i>UCITS Directive</i> , as well as an <i>undertaking</i> the registered office of which is outside the <i>EEA</i> and which would require authorisation in accordance with Article 5(1) of the <i>UCITS Directive</i> if it had its registered office within the <i>EEA</i> .
<i>asset-related capital requirement</i>	a component of the calculation of the <i>ECR</i> for a <i>firm</i> carrying on <i>general insurance business</i> as set out in <i>PRU 3.3</i> .
<i>asset share</i>	the <i>premiums</i> paid by the <i>policyholder</i> , less deductions for expenses, tax and other charges, plus allocations of business profits, accumulated at the rate of investment return achieved.
<i>base capital resources requirement</i>	an amount of <i>capital resources</i> that a <i>firm</i> must hold as set out in the table in <i>PRU 2.1.27R</i> .
<i>brought forward amount</i>	an amount, as defined in <i>PRU 7.2.52R</i> , used in the calculation of the <i>general insurance capital requirement</i> .
<i>capital resources</i>	in relation to a <i>firm</i> , the <i>firm's</i> capital resources as calculated in accordance with <i>PRU 2.2.12R</i> .

<i>capital resources requirement</i>	an amount of <i>capital resources</i> that a <i>firm</i> must hold as set out in <i>PRU 2.1.15R</i> to <i>PRU 2.1.21R</i> .	
<i>claim</i>	a claim against an <i>insurer</i> under a <i>contract of insurance</i> .	
<i>claims amount</i>	an amount, as defined in <i>PRU 7.2.48R</i> , used in the calculation of the <i>general insurance capital requirement</i> .	
<i>class</i>	(1)	(in <i>AUTH</i> , <i>IPRU(FSOC)</i> , <i>PRU</i> , <i>LLD</i> and <i>SUP</i>) (in relation to a <i>contract of insurance</i>) any class of <i>contract of insurance</i> listed in Schedule 1 to the <i>Regulated Activities Order</i> (Contracts of insurance).
	(2)	(in <i>COLL</i> and <i>CIS</i>): (a) a particular class of <i>units</i> of an <i>authorised fund</i> ; or (b) all of the <i>units</i> relating to a single <i>sub-fund</i> ; or (c) a particular class of <i>units</i> relating to a single <i>sub-fund</i> .
	(3)	(in <i>COB</i>) a particular category or type of <i>packaged product</i> .
<i>commitment</i>	a commitment represented by <i>insurance business</i> of any of the <i>classes of long-term insurance business</i> .	
<i>compensation fund</i>	any <i>policyholder</i> compensation scheme in any <i>EEA State</i> .	
<i>composite firm</i>	a <i>firm</i> that carries on both <i>long-term insurance business</i> and <i>general insurance business</i> .	
<i>collateral</i>	an asset that is subject to a mortgage, charge, pledge or other security interest.	

consolidation Article 12(1) relationship	<p>a relationship between one <i>undertaking</i> (the first undertaking) and one or more <i>undertakings</i> satisfying the conditions set out in Article 12(1) of the <i>Seventh Company Law Directive</i>, which in summary are as follows:</p> <p>(1) those <i>undertakings</i> are not connected, as described in article 1(1) or (2) of that Directive; and</p> <p>(2) one of the following conditions is satisfied:</p> <p>(a) they are managed on a unified basis pursuant to a contract concluded with the first undertaking or provisions in the memorandum or articles of association of those <i>undertakings</i>; or</p> <p>(b) the administrative, management or supervisory bodies of those <i>undertakings</i> consist for the major part of the same <i>persons</i> in office during the financial year in respect of which it is being decided whether such a relationship exists.</p>	
consolidation group	<p>the following:</p> <p>(1) a <i>conventional group</i>; or</p> <p>(2) <i>undertakings</i> linked by a <i>consolidation Article 12(1) relationship</i></p> <p>If a <i>parent undertaking</i> or <i>subsidiary undertaking</i> in a <i>conventional group</i> (the first person) has a <i>consolidation Article 12(1) relationship</i> with another <i>person</i> (the second person) the second person (and any <i>subsidiary undertakings</i> of the second person) is also a member of the same <i>consolidation group</i>.</p>	
contract of insurance	<p>as described in Article 3 (1) of the Regulated Activities Order (interpretation: general), any <i>contract of insurance</i> which is a <i>long-term insurance contract</i> or a <i>general insurance contract</i>.</p>	
control	(1)	(except in <i>PRU 3.2</i>) (in relation to the acquisition, increase or reduction of control of a <i>firm</i>) the relationship between a <i>person</i> and the <i>firm</i> or other <i>undertaking</i> of which the <i>person</i> is a <i>controller</i> .
	(2)	(in <i>PRU 3.2</i>) means the relationship between a <i>parent undertaking</i> and a <i>subsidiary</i> , as defined in Article 1 of the Consolidated Accounts Directive (83/349/EEC), or a similar relationship between any natural or legal person and an <i>undertaking</i> .

conventional group	a group of <i>undertakings</i> that consists of a <i>parent undertaking</i> and the rest of its <i>sub-group</i> .
core tier one capital	an item of capital that is stated in section A of the table in <i>PRU</i> 2.2.14R to be core tier one capital.
counterparty	In relation to an <i>insurer</i> – (a) any one individual; or (b) any one unincorporated body of <i>persons</i> ; or (c) any <i>company</i> which is not a member of a <i>group</i> ; or (d) any <i>group</i> of <i>companies</i> excluding any <i>companies</i> within the <i>group</i> which are <i>subsidiary undertakings</i> of the <i>insurer</i> ; or (e) any government of a State together with all the public bodies, local authorities or nationalised industries of that State, in which the <i>insurer</i> , or any of its <i>subsidiary undertakings</i> , has made <i>investments</i> or against whom, or in respect of whom, it, or any of its <i>subsidiary undertakings</i> , has rights or obligations under a contract entered into by the <i>insurer</i> or any of its <i>subsidiary undertakings</i> .
coupon	means a dividend, interest payment or any similar payment.
credit equalisation provision	the provision required to be established by <i>PRU</i> 7.5.44R.
credit risk	(in relation to a <i>firm</i>) the risk of loss if another party fails to perform its financial obligations to the <i>firm</i> .
CRR	<i>capital resources requirement</i> .
deposit back arrangement	(in <i>PRU</i>) in relation to any contract of <i>reinsurance</i> , means an arrangement whereby an amount is deposited by the <i>reinsurer</i> with the cedant.
discounting	(in <i>PRU</i>) refers to discounting or deductions to take account of investment income within the meaning of paragraph 48 of the <i>insurance accounts rules</i> .
earned gross premiums	see under ' <i>gross earned premiums</i> '.
ECR	<i>enhanced capital requirement</i> .

EEA-deposit insurer	a <i>non-EEA insurer</i> that has made a deposit in an <i>EEA State</i> (other than the <i>United Kingdom</i>) under article 23 of the <i>First Non-Life Directive</i> (as amended) in accordance with article 26 of that Directive or under article 51 of the <i>Life Assurance Directive</i> in accordance with article 56 of that Directive.
EEA firm	<p>(in accordance with paragraph 5 of Schedule 3 to the <i>Act</i> (EEA Passport Rights)) any of the following, if it does not have its head office in the <i>United Kingdom</i>:</p> <ul style="list-style-type: none"> (a) an investment firm (as defined in article 1(2) of the <i>Investment Services Directive</i>) which is authorised (within the meaning of article 3) by its <i>Home State regulator</i>; (b) a <i>credit institution</i> which is authorised (within the meaning of article 1) by its <i>Home State regulator</i>; (c) a financial institution (as defined in article 1 of the <i>Banking Consolidation Directive</i>) which is a subsidiary of the kind mentioned in article 19 and which fulfils the conditions in articles 18 and 19; (d) an undertaking pursuing the activity of direct insurance (within the meaning of article 1 of the <i>Life Assurance Directive</i> or of the <i>First Non-Life Directive</i> (as amended)) which has received authorisation under article 6 from its <i>Home State regulator</i>. (e) [reserved for amendments implementing the Insurance Mediation Directive] (f) (from 13 February 2004) a management company (as defined in article 1a of the <i>UCITS Directive</i>) which has been authorised under article 5 of that directive by its <i>Home State regulator</i>.
EEA MCR	(in <i>PRU 7.6</i>) <i>MCR</i> calculated by a <i>UK-deposit insurer</i> in relation to business carried on in all member states of the <i>EEA</i> , taken together.
EEA regulated entity	a <i>regulated entity</i> that is an <i>EEA firm</i> or a <i>UK firm</i> .

enhanced capital requirement	(1)	(in relation to a <i>firm</i> carrying on <i>general insurance business</i>) the amount calculated in accordance with <i>PRU 2.3.11R</i> .
	(2)	(in relation to a <i>firm</i> carrying on <i>long-term insurance business</i>) an amount of <i>capital resources</i> that a <i>firm</i> must hold as set out in <i>PRU 2.1.35R</i> .
equalisation provision	a provision required to be established under the <i>rules</i> in <i>PRU 7.5</i> .	
equity market adjustment ratio	has the meaning set out in the <i>resilience capital requirement</i> in <i>PRU 4.2.20R</i> and the <i>market risk</i> scenario for the <i>risk capital margin</i> of a <i>with-profits fund</i> in <i>PRU 7.4.68R</i> .	
established surplus	(1)	an excess of assets representing the whole or a particular part of the <i>long-term insurance fund</i> or <i>funds</i> over the liabilities, or a particular part of the liabilities, of the <i>insurer</i> attributable to that business as shown by an <i>actuarial investigation</i> ; and
	(2)	(for the purposes of <i>PRU 7.6</i>) no more than three months have passed since the date in respect of which the determination was made.
final bonus	(in relation to a <i>with-profits insurance contract</i>) a discretionary payment which might be made by a <i>long-term insurer</i> in addition to the guaranteed benefits when the benefits under the <i>with-profits insurance contract</i> become payable.	
financial conglomerate	(in accordance with Article 2(14) of the <i>Financial Groups Directive</i> (Definitions)) a <i>consolidation group</i> that is identified as a <i>financial conglomerate</i> by the <i>financial conglomerate definition decision tree</i> .	
financial conglomerate definition decision tree	the decision tree in <i>PRU 8 Annex 5</i> .	
Financial Groups Directive	Directive 2002/87/EC of the European Parliament and of the Council of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a <i>financial conglomerate</i> .	

financial holding company	(in <i>PRU</i>) a <i>financial institution</i> that fulfils the following conditions: (1) its <i>subsidiary undertakings</i> are either exclusively or mainly <i>credit institutions</i> , <i>investment firms</i> or <i>financial institutions</i> ; (2) at least one of those <i>subsidiary undertakings</i> is a <i>credit institution</i> or <i>investment firm</i> ; and (3) it is not a <i>mixed financial holding company</i> .	
financial year	(1)	(in <i>DISP</i>) the 12 <i>months</i> ending with 31 March.
	(2)	(in <i>LLD</i>) a calendar year.
	(3)	(for the purposes of <i>PRU 2.2</i> , <i>PRU 7.2</i> , <i>PRU 7.3</i> and <i>PRU 7.5</i>) the period at the end of which the balance of the accounts of the <i>insurer</i> is struck, or, if no balance is struck, the calendar year.
financial year in question	(for the purposes of <i>PRU 7.2</i>) the last <i>financial year</i> to end before the date on which the latest accounts of the <i>insurer</i> are required to be deposited with the <i>FSA</i> .	
financing cost amount	(in relation to a <i>share</i> , <i>debenture</i> or other investment in, or external contribution to the capital of, a <i>firm</i>) an amount that represents a reasonable estimate of the part of the <i>coupon</i> on that instrument that reflects the cost of financing generally but excludes costs reflecting factors relating to the issuer, guarantor or other person to whom the instrument creates an exposure.	
firm in run-off	a <i>firm</i> whose <i>Part IV permission</i> has been varied so as to remove the <i>regulated activity</i> of <i>effecting contracts of insurance</i> .	
future policy-related liabilities	the future policy-related liabilities of the <i>with-profits fund</i> calculated in accordance with <i>PRU 7.4.135R</i> to <i>PRU 7.4.187G</i> .	
GICR	<i>general insurance capital requirement</i> .	
general insurance capital requirement	the highest of the <i>premiums amount</i> , <i>claims amount</i> and <i>brought forward amount</i> as set out in <i>PRU 7.2</i> .	

general insurance liabilities	(in <i>PRU</i>) liabilities arising from <i>general insurance business</i> .	
gross adjusted claims amount	(for the purposes of <i>PRU</i> 7.2) an amount, as defined in <i>PRU</i> 7.2.61R to <i>PRU</i> 7.2.66G, used in calculating the <i>claims amount</i> .	
gross adjusted premiums amount	(for the purposes of <i>PRU</i> 7.2) an amount as defined in <i>PRU</i> 7.2.57R to <i>PRU</i> 7.2.60G, used in calculating the <i>premiums amount</i> .	
gross earned premiums	(in relation to a <i>financial year</i>) such proportion of <i>gross written premiums</i> as is attributable to risk borne by the <i>insurer</i> during that <i>financial year</i> .	
gross written premiums	the amounts required by the <i>insurance accounts rules</i> to be shown in the profit and loss account of an <i>insurer</i> at general business technical account item I.1.(a), or for <i>class IV insurance business</i> , at long-term business technical account item II.1(a).	
group capital resources	has the meaning in <i>PRU</i> 8.3.32R.	
guarantee fund	(1)	<p>(a) subject to (b), in relation to a <i>firm</i> carrying on <i>general insurance business</i>, the higher of one third of the <i>general insurance capital requirement</i> and the <i>base capital resources requirement</i> applicable to that <i>firm</i>;</p> <p>(b) where the <i>firm</i> is required to calculate a <i>UK MCR</i> or an <i>EEA MCR</i> under <i>PRU</i> 7.6, for the purposes of that section the reference in (a) to the <i>general insurance capital requirement</i> is replaced by <i>UK MCR</i> or <i>EEA MCR</i>, as appropriate;</p>
	(2)	<p>(a) subject to (b), in relation to a <i>firm</i> carrying on <i>long-term insurance business</i>, the higher of one third of the <i>long-term insurance capital requirement</i> and the <i>base capital resources requirement</i> applicable to that <i>firm</i>;</p> <p>(b) where the <i>firm</i> is required to calculate a <i>UK MCR</i> or an <i>EEA MCR</i> under <i>PRU</i> 7.6, for the purposes of that section the reference in (a) to the <i>long-term insurance capital requirement</i> is replaced by <i>UK MCR</i> or <i>EEA MCR</i>, as appropriate.</p>
IBNR	in relation to <i>claims</i> , <i>claims</i> that have been incurred but not reported arising out of events that have occurred by the balance sheet date but have not been reported to the <i>insurance undertaking</i> at that date.	

<i>implicit items</i>	(in relation to <i>long-term insurance business</i>) economic reserves arising in respect of future profits, <i>zillmerising</i> or hidden reserves as more fully described in <i>PRU 2.2 Annex 2G</i> .
<i>index-linked benefits</i>	benefits: (1) provided for under a <i>linked long-term contract of insurance</i> ; and (2) determined by reference to an index of the value of property of any description (whether specified in the contract or not).
<i>index-linked liabilities</i>	insurance liabilities in respect of <i>index-linked benefits</i> .
<i>initial capital</i>	<p>(1) (in <i>ELM</i>) items coming into stage A of the calculation in <i>ELM 2.4.2R</i> (Calculation of initial capital and own funds).</p> <p>(2) (for the purposes of the definition of <i>matched principal dealer</i>, in accordance with Article 2(24) of the <i>Capital Adequacy Directive</i> (Definitions) and with respect to a <i>firm</i>) capital that is recognised for the purpose of the <i>rules</i> about capital adequacy to which that <i>firm</i> is subject but excluding, in accordance with items (1) and (2) of Article 34(2) of the <i>Banking Consolidation Directive</i> (General principles), anything that does not fall within the following classes of capital:</p> <p style="padding-left: 40px;">(a) capital within the meaning of Article 22 of the <i>Bank Accounts Directive</i> (Liabilities: Item 9 – Subscribed capital), insofar as it has been paid up, plus share premium accounts but excluding cumulative preferential shares;</p> <p style="padding-left: 40px;">(b) reserves within the meaning of Article 23 of the <i>Bank Accounts Directive</i> (Liabilities: Item 11 – Reserves) and profits and losses brought forward as a result of the application of the final profit or loss. Interim profits can only be included before a formal decision has been taken only if these profits have been verified by <i>persons</i> responsible for the auditing of the accounts and if the amount thereof has been evaluated in accordance with the principles set out in the <i>Bank Accounts Directive</i> and is net of any foreseeable charge or dividend.</p> <p>In the case of a <i>firm</i> subject to the <i>rules</i> in chapter 10 of <i>IPRU(INV)</i>, initial capital means initial capital as defined in the Glossary to that chapter.</p>
<i>initial coupon rate</i>	(in relation to a <i>tier one instrument</i>) the <i>coupon</i> rate of the instrument at the time it is issued.

<i>initial credit spread</i>	(in relation to a <i>tier one instrument</i>) the <i>initial coupon rate</i> less the <i>original financing cost amount</i> , and where the resulting amount is a negative figure, the initial credit spread is deemed to be zero.
<i>initial fund</i>	the items of capital which are available to a <i>mutual</i> at <i>authorisation</i> .
<i>innovative tier one capital</i>	an item of capital that is stated in section C of the table in <i>PRU</i> 2.2.14R to be innovative tier one capital.
<i>innovative tier one capital resources</i>	the amount of <i>capital resources</i> at stage C of the table in <i>PRU</i> 2.2.14R.
<i>innovative tier one instrument</i>	a <i>potential tier one instrument</i> that is stated in <i>PRU</i> 2.2.52R to <i>PRU</i> 2.2.69R to be an innovative instrument.
<i>insurance business grouping</i>	a grouping comprising descriptions of <i>general insurance business</i> determined in accordance with <i>PRU</i> 7.5.13R.
<i>insurance death risk capital component</i>	one of the components of the <i>long-term insurance capital requirement</i> as set out in <i>PRU</i> 7.2.82R to <i>PRU</i> 7.2.85G.
<i>insurance expense risk capital component</i>	one of the components of the <i>long-term insurance capital requirement</i> as set out in <i>PRU</i> 7.2.89R.
<i>insurance group</i>	an <i>insurance parent undertaking</i> and its <i>related undertakings</i> .
<i>Insurance Groups Directive</i>	Directive of the European Parliament and of the Council of 27 October 1998 on the supplementary supervision of <i>insurance undertakings</i> in an <i>insurance group</i> (1998/78/EC).
<i>insurance health risk capital component</i>	one of the components of the <i>long-term insurance capital requirement</i> as set out in <i>PRU</i> 7.2.86R to <i>PRU</i> 7.2.88G.
<i>insurance holding company</i>	<p>a <i>parent undertaking</i>, other than an <i>insurance undertaking</i>, the main business of which is to acquire and hold participations in <i>subsidiary undertakings</i> and that fulfils the following conditions:</p> <p>(1) its <i>subsidiary undertakings</i> are either exclusively or mainly <i>insurance undertakings</i>;</p> <p>(2) at least one of those <i>subsidiary undertakings</i> is a <i>UK insurer</i> or an <i>EEA firm</i> that is an <i>insurer entity</i>; and</p> <p>(3) it is not a <i>mixed financial holding company</i>.</p> <p>For the purposes of:</p> <p>(4) the definition of the <i>insurance sector</i>; and</p> <p>(5) <i>ELM</i>;</p> <p>paragraph (2) of this definition does not apply.</p>
<i>insurance market risk capital component</i>	one of the components of the <i>long-term insurance capital requirement</i> as set out in <i>PRU</i> 7.2.90R.

<i>insurance parent undertaking</i>	a <i>parent undertaking</i> which is: (1) an <i>insurer</i> which has a <i>subsidiary undertaking</i> that is an <i>insurance undertaking</i> ; or (2) an <i>insurance holding company</i> which has a <i>subsidiary undertaking</i> which is an <i>insurer</i> ; or (3) an <i>insurance undertaking</i> which has a <i>subsidiary undertaking</i> which is an <i>insurer</i> .
<i>insurance-related capital requirement</i>	a component of the calculation of the <i>ECR</i> for a <i>firm</i> carrying on <i>general insurance business</i> as set out in <i>PRU 7.2.74G</i> to <i>PRU 7.2.80R</i> .
<i>insurance sector</i>	a sector composed of one or more of the following entities: (1) an <i>insurance undertaking</i> ; (2) an <i>insurance holding company</i> ; and (in the circumstances described in <i>PRU 8.4.61R</i> (The financial sectors: Asset management companies)) an <i>asset management company</i> .
<i>Life Assurance Directive</i>	the Directive of the European Parliament and of the Council of 5 November 2002 concerning life assurance (No 2002/83/EC).
<i>liquidity risk</i>	the risk that a <i>firm</i> , although solvent, either does not have available sufficient financial resources to enable it to meet its obligations as they fall due, or can secure such resources only at excessive cost.
<i>local capital resources requirement</i>	capital resources requirement imposed by the <i>Home State regulator</i> .
<i>long-term admissible asset</i>	(in <i>PRU</i>) a <i>long-term insurance asset</i> which is an <i>admissible asset</i> .
<i>long-term insurance asset</i>	(in <i>PRU</i>) an asset described as a long-term insurance asset in <i>PRU 7.6</i> available to meet <i>long-term insurance liabilities</i> .
<i>long-term insurance capital requirement</i>	(in relation to a <i>firm</i> carrying out <i>long-term insurance business</i>) an amount of <i>capital resources</i> that a <i>firm</i> must hold calculated in accordance with <i>PRU 2.1.33R</i> .
<i>long-term insurance fund</i>	a fund maintained under <i>PRU 7.6.21R</i> .
<i>long-term insurance liabilities</i>	(in <i>PRU</i>) liabilities arising from <i>long-term insurance business</i> .

<i>long-term insurance surplus</i>	the excess, if any, of the value of <i>long-term insurance assets</i> over the amount of <i>long-term insurance liabilities</i> .
<i>lower tier two capital</i>	an item of capital that is specified in section H of the table in <i>PRU</i> 2.2.14R.
<i>lower tier two capital resources</i>	the sum calculated at stage H of the calculation in <i>PRU</i> 2.2.14R.
<i>lower tier two instrument</i>	an item of capital that falls into <i>PRU</i> 2.2.108R and is eligible to form part of a <i>firm's lower tier two capital resources</i> .
<i>LTICR</i>	<i>long-term insurance capital requirement</i> .
<i>management expenses</i>	in relation to <i>long-term insurance business</i> , means all expenses, other than commission, incurred in the administration of an <i>insurer</i> or its business.
<i>market risk</i>	(in relation to a <i>firm</i>) the risks that arise from fluctuations in values of, or income from, assets or in interest or exchange rates.
<i>matched principal broker</i>	<p>a <i>firm</i> with <i>permission to deal in investments as principal</i> other than:</p> <p>(1) a <i>bank</i>, a <i>building society</i> or an <i>ELMI</i>;</p> <p>(2) a <i>UCITS management company</i>;</p> <p>(3) an <i>insurer</i>; or</p> <p>(4) a <i>local</i>;</p> <p>and which satisfies the following conditions:</p> <p>(5) it <i>deals</i> as principal only to fulfil customer orders;</p> <p>(6) it holds positions for its own account only as a result of a failure to match investors' orders precisely;</p> <p>(7) the total market value of the positions is no higher than 15% of the <i>firm's initial capital</i>; and</p> <p>the positions are incidental and provisional in nature and strictly limited to the time required to carry out the transaction in question.</p>
<i>mathematical reserves</i>	(in <i>PRU</i>) the provision made by an <i>insurer</i> to cover liabilities (excluding liabilities which have fallen due and liabilities arising from <i>deposit back arrangements</i>) arising under or in connection with <i>long-term insurance contracts</i> .

<i>member contribution</i>	<p>any paid up contribution by a member of a <i>mutual</i> where the members' accounts meet the following criteria:</p> <ol style="list-style-type: none"> (1) the memorandum and articles of association or other constitutional documents must stipulate that payments may be made from these accounts to members only in so far as this does not cause the <i>capital resources</i> to fall below the required level, or, if after dissolution of the <i>firm</i>, all the <i>firm's</i> other debts have been settled; (2) the memorandum and articles of association or other constitutional documents must stipulate, with respect to the payments referred to in (1) made for reasons other than the individual termination of membership, that the <i>FSA</i> must be notified at least one month in advance of the intended date of such payments; and (3) the <i>FSA</i> must be notified of any amendment to the relevant provisions of the memorandum and articles of association or other constitutional documents.
<i>MCR</i>	<i>minimum capital requirement.</i>
<i>minimum capital requirement</i>	an amount of <i>capital resources</i> that a <i>firm</i> must hold as set out in <i>PRU 2.1.22R</i> and <i>PRU 2.1.23R</i> .
<i>mixed financial holding company</i>	(in accordance with Article 2(15) of the <i>Financial Groups Directive</i> (Definitions)) a <i>parent undertaking</i> , other than a <i>regulated entity</i> , which together with its <i>subsidiary undertakings</i> , at least one of which is an <i>EEA regulated entity</i> , and other entities, constitutes a <i>financial conglomerate</i> .
<i>mutual</i>	<p>an <i>insurer</i> which:</p> <ol style="list-style-type: none"> (1) if it is a <i>body corporate</i> has no <i>share capital</i> (except a wholly owned <i>subsidiary</i> with no <i>share capital</i> but limited by guarantee); or (2) is a <i>registered or incorporated friendly society</i>; or (3) is a society registered or deemed to be registered under the Industrial and Provident Societies Act 1965 or the Industrial and Provident Societies (Northern Ireland) Act 1969.
<i>net earned premiums</i>	<i>gross earned premiums</i> , net of <i>reinsurance premiums</i> earned.

net premium	in <i>PRU 7.3</i> , the premium that is calculated to provide the basic sum assured under a <i>with-profits insurance contract</i> taking into consideration only the mortality and interest rate risks and using the same assumptions as used in the calculation of the <i>mathematical reserves</i> .	
net written premiums	<i>gross written premiums</i> , net of <i>reinsurance premiums</i> payable under <i>reinsurance ceded</i> .	
non-credit equalisation provision	the provision required to be established under <i>PRU 7.5.18R</i> .	
non-directive insurer	(1)	an <i>insurer</i> whose <i>insurance business</i> is restricted to the provision of benefits which vary according to the resources available and in which the contributions are determined on a flat-rate basis; or
	(2)	an <i>insurer</i> whose <i>long-term insurance business</i> is restricted to the provision of benefits for employed and self-employed persons belonging to an undertaking or group of undertakings, or a trade or group of trades, in the event of death or survival or of discontinuance or curtailment of activity (whether or not the <i>commitments</i> arising from such operations are fully covered at all times by <i>mathematical reserves</i>); or
	(3)	an <i>insurer</i> which undertakes to provide benefits solely in the event of death where the amount of such benefits does not exceed the average funeral costs for a single death or where the benefits are provided in kind; or
	(4)	a <i>mutual</i> (carrying on <i>long-term insurance business</i>) whose: <ul style="list-style-type: none"> (a) articles of association contain provisions for calling up additional contributions from members or reducing their benefits or claiming assistance from other persons who have undertaken to provide it; and (b) annual gross <i>premium</i> income (other than from contracts of <i>reinsurance</i>) has not exceeded 5 million Euro for each of the <i>financial year in question</i> and the two <i>previous financial years</i>; or
	(5)	a <i>mutual</i> (carrying on <i>general insurance business</i>) whose: <ul style="list-style-type: none"> (a) articles of association contain provisions for calling up additional contributions from members or reducing their benefits;

	<ul style="list-style-type: none"> (b) business does not cover liability risks, other than <i>ancillary risks</i>, or credit or suretyship risks; (c) gross <i>premium</i> income (other than from contracts of <i>reinsurance</i>) for the <i>financial year in question</i> did not exceed 5 million Euro; and (d) members provided at least half of that gross <i>premium</i> income; or
	<p>(6) an <i>insurer</i> whose <i>insurance business</i> (other than <i>reinsurance</i>) is:</p> <ul style="list-style-type: none"> (a) restricted to the provision of assistance for persons who get into difficulties while travelling, while away from home or while away from their permanent residence; (b) carried out exclusively on a local basis and consists only of benefits in kind; and (c) such that the gross <i>premium</i> income from the provision of assistance in the <i>financial year in question</i> did not exceed 200,000 Euro; or
	<p>(7) (a) a <i>mutual</i> whose liabilities in respect of <i>general insurance contracts</i> are fully reinsured with or guaranteed by other <i>mutuals</i> (including <i>friendly societies</i>); and</p> <p>(b) the <i>mutuals</i> providing the reinsurance or the guarantee are subject to the rules of the <i>First Non-Life Directive</i>.</p>
non-directive mutual	a <i>mutual</i> that falls into sections (4), (5) or (7) of the definition of a <i>non-directive insurer</i> .
non-EEA direct insurer	an <i>insurer</i> , other than a <i>pure reinsurer</i> , whose head office is not in an <i>EEA State</i> .
non-EEA insurer	an <i>insurer</i> whose head office is not in an <i>EEA State</i> .
non-EEA undertaking	an <i>undertaking</i> which is incorporated in, or formed under the laws of, a country or territory outside the <i>EEA</i> .
non-profit insurance business	the business of effecting or carrying out <i>non-profit insurance contracts</i> .
non-profit insurance contract	a <i>long-term insurance contract</i> which is not a <i>with-profits insurance contract</i> .
non-proportional reinsurance treaty	see ' <i>proportional reinsurance treaty</i> '.

nuclear risks	risks falling within any class of <i>general insurance business</i> and arising in connection with the construction and use of any nuclear reactor or nuclear installation or the carriage on any nuclear matter.	
original financing cost amount	(in relation to a <i>share</i> , <i>debenture</i> or other investment in, or external contribution to the capital of, a <i>firm</i> that is subject to a <i>step-up</i>) the <i>financing cost amount</i> for the instrument for a period beginning on or near the date of issue of the instrument and ending on or near the date of the first <i>step-up</i> .	
own account dealer	a <i>firm</i> with <i>permission to deal in investments as principal</i> other than:	
	(1)	a <i>bank</i> , a <i>building society</i> or an <i>ELMI</i> ; or
	(2)	an <i>insurer</i> ; or
	(3)	a <i>UCITS management company</i> ; or
	(4)	a <i>matched principal broker</i> ; or
	(5)	a <i>local</i> .
participating insurance undertaking	an <i>insurance undertaking</i> that holds a <i>participation</i> in one or more other <i>insurance undertakings</i> , none of which is its <i>subsidiary undertaking</i> .	
participating undertaking	an <i>undertaking</i> which is either a <i>parent undertaking</i> or other <i>undertaking</i> which holds a <i>participation</i> in or is linked by a <i>consolidation Article 12(1) relationship</i> with the undertaking in question.	
participation	(for the purposes of <i>ELM</i> and <i>PRU 8</i> (Group risk)): (1) a participating interest as defined in section 260 of the Companies Act 1985; or (2) the direct or indirect ownership of 20% or more of the voting rights or capital of an <i>undertaking</i> ; but excluding the interest of a <i>parent undertaking</i> in its <i>subsidiary undertaking</i> .	
permanent share capital	an item of capital that is stated in <i>PRU 2.2.36R</i> to be permanent share capital.	
potential tier one instrument	an item of capital that falls into <i>PRU 2.2.27R</i> .	
preference share	a <i>share</i> with rights, in respect of capital or dividends, superior to those of ordinary <i>shares</i> .	

<i>premiums amount</i>	(for the purposes of <i>PRU 7.2</i>), an amount, as defined in <i>PRU 7.2.46R</i> , used in the calculation of the <i>general insurance capital requirement</i> .
<i>property-linked benefits</i>	benefits other than <i>index-linked benefits</i> provided for under a <i>linked long-term contract of insurance</i> .
<i>property-linked liabilities</i>	insurance liabilities in respect of <i>property-linked benefits</i> .
<i>proportional reinsurance treaty</i>	a <i>reinsurance</i> treaty under which a pre-determined proportion of each <i>claim</i> payment by the cedant under <i>policies</i> subject to the treaty is recoverable from the <i>reinsurer</i> . <i>non-proportional reinsurance treaty</i> is construed accordingly.
<i>proxy capital resources requirement</i>	the <i>minimum capital requirement</i> to which an undertaking would have been subject if it had a <i>permission</i> for each activity it carries on anywhere in the world, so far as that activity is a <i>regulated activity</i> .
<i>PRU</i>	the Integrated Prudential Sourcebook.
<i>quasi-derivative</i>	a contract or asset having the effect of a <i>derivative</i> contract.
<i>real estate adjustment ratio</i>	has the meaning set out in the <i>resilience capital requirement</i> in <i>PRU 4.2.22R</i> .
<i>realistic basis life firm</i>	a <i>firm</i> to which <i>PRU 2.1.16R</i> applies (and which is therefore required to calculate a <i>with profits insurance capital component</i> in accordance with <i>PRU 7.4</i>).
<i>realistic current liabilities</i>	(in relation to a <i>with-profits fund</i>) the realistic current liabilities of the <i>with-profits fund</i> calculated in accordance with <i>PRU 7.4.188R</i> .
<i>realistic excess capital</i>	(in relation to a <i>with-profits fund</i>) the excess, if any, of the <i>realistic value of assets</i> for the <i>with-profits fund</i> over the sum of the <i>realistic value of liabilities</i> and the <i>risk capital margin</i> for that fund, calculated in accordance with <i>PRU 7.4.31R</i> .
<i>realistic value of assets</i>	(in relation to a <i>with-profits fund</i>) has the meaning set out in <i>PRU 7.4.32R</i> .
<i>realistic value of liabilities</i>	(in relation to a <i>with-profits fund</i>) the sum of the <i>with-profits benefit reserve</i> , the <i>future policy related liabilities</i> and the <i>realistic current liabilities</i> for the <i>with-profits fund</i> .

<i>regulated entity</i>	<p>one of the following: (1) a <i>credit institution</i>; (2) a <i>regulated insurance entity</i>; or (3) an <i>investment firm</i>; whether or not it is incorporated in, or has its head office in an <i>EEA State</i>.</p> <p>An <i>asset management company</i> is treated as a regulated entity for the purposes described in <i>PRU 8.4.61R</i> (The financial sectors: asset management companies).</p>
<i>regulated insurance entity</i>	<p>an <i>insurance undertaking</i> within the meaning of Article 4 of the <i>Life Assurance Directive</i>, Article 6 of the <i>First Non-Life Directive</i> or Article 1(b) of the <i>Insurance Groups Directive</i>.</p>
<i>regulated market</i>	<p>a market which is characterised by -</p> <p>(a) regular operation;</p> <p>(b) the fact that regulations issued or approved by the appropriate authority of the state where the market is situated -</p> <p style="padding-left: 40px;">(i) define the conditions for the operation of and access to the market,</p> <p style="padding-left: 40px;">(ii) define the conditions to be satisfied by a financial instrument in order for it to be effectively dealt in on the market, and</p> <p style="padding-left: 40px;">(iii) require compliance with reporting and transparency requirements comparable to those laid down in articles 20 and 21 of the <i>Investment Services Directive</i>, and</p> <p>(c) in the case of a market situated outside the <i>EEA States</i>, the fact that the financial instruments dealt in are of a quality comparable to those in a regulated market in the <i>United Kingdom</i>.</p>
<i>regulated related undertaking</i>	<p>a <i>related undertaking</i> that is any of the following:</p> <p>(a) a <i>regulated entity</i>,</p> <p>(b) an <i>insurance undertaking</i> which is not a <i>regulated insurance entity</i>,</p> <p>(c) an <i>asset management company</i>,</p> <p>(d) a <i>financial institution</i> which is not either a <i>credit institution</i> or <i>investment firm</i>,</p>

	<p>(e) a <i>financial holding company</i>, or</p> <p>(f) an <i>insurance holding company</i>.</p>
regulatory basis only life firm	a <i>firm</i> carrying on <i>long-term insurance business</i> which is not a <i>realistic basis life firm</i> .
regulatory current liabilities	(in relation to a <i>with-profits fund</i>) the regulatory current liabilities of the <i>with-profits fund</i> calculated in accordance with <i>PRU 7.4.29R</i> .
regulatory excess capital	(in relation to a <i>with-profits fund</i>) has the meaning set out in <i>PRU 7.4.22R</i> .
regulatory surplus	(in relation to a <i>long-term business fund</i> , or sub-fund) the excess, if any, of the <i>regulatory value of assets</i> for the <i>with-profits fund</i> over the <i>regulatory value of liabilities</i> for that fund.
regulatory surplus value	has the meaning set out in <i>PRU 1.3.36R</i> .
regulatory value of assets	(in relation to a <i>with-profits fund</i>) has the meaning set out in <i>PRU 7.4.23 R</i> and <i>PRU 7.4.24 R</i> .
regulatory value of liabilities	(in relation to a <i>with-profits fund</i>) has the meaning set out in <i>PRU 7.4.27R</i> .
reinsurance	includes retrocession.
reinsurance ratio	(for the purposes of <i>PRU 7.2</i>), the ratio, as defined in <i>PRU 7.2.55R</i> to <i>PRU 7.2.56G</i> , used in the calculation of the <i>premiums amount</i> and the <i>claims amount</i> .
reinsurer	<p>an <i>insurer</i> whose business includes effecting or carrying out contracts of <i>reinsurance</i>.</p> <p>Includes retrocessionnaire.</p>

<i>related undertaking</i>	<p>in relation to an <i>undertaking</i> 'U':</p> <ul style="list-style-type: none"> (a) any <i>subsidiary undertaking</i> of U: or (b) any <i>undertaking</i> in which U or any of U's <i>subsidiary undertakings</i> holds a <i>participation</i>; or (c) any <i>undertaking</i> linked to U by a <i>consolidation Article 12(1) relationship</i>; or (d) any <i>undertaking</i> linked by a <i>consolidation Article 12(1) relationship</i> to an <i>undertaking</i> in (a), (b) or (c).
<i>relevant capital sum</i>	<p>for the purposes of <i>PRU 7.3.44 R</i>:</p> <ul style="list-style-type: none"> (a) Subject to (b), <i>relevant capital sum</i> under a <i>contract of insurance</i> means - <ul style="list-style-type: none"> (i) for whole life assurances, the sum assured; (ii) for <i>policies</i> where a sum is payable on maturity (including <i>policies</i> where a sum is also payable on earlier death), the sum payable on maturity; (iii) for deferred annuities, the capitalised value of the annuity at the vesting date (or the cash option if it is greater); (iv) for capital redemption contracts, the sum payable at the end of the contract period, and (v) for <i>linked long-term contracts of insurance</i>, notwithstanding (i) to (iv), the lesser of: <ul style="list-style-type: none"> (A) the amount for the time being payable on death; and (B) the aggregate of the value for the time being of the units allocated to the contract (or, where entitlement is not denoted by means of units, the value for the time being of any other measure of entitlement under the contract equivalent to units) and the total amount of the <i>premiums</i> remaining to be paid during such of the term of the contract as is appropriate for <i>zillmerising</i> or, if such <i>premiums</i> are payable beyond the age of seventy-five, until that age; <p>Excluding in all cases any vested reversionary bonus;</p>

	(b) Notwithstanding (a), for temporary assurances, the <i>relevant capital sum</i> means the sum assured on the <i>relevant date</i> .	
relevant insurer	in relation to a <i>relevant co-insurance operation</i> , an <i>insurer</i> which is concerned in the operation but is not the <i>leading insurer</i> .	
resilience capital requirement	the capital component for <i>long-term insurance business</i> calculated in accordance with <i>PRU 4.2.10G</i> to <i>PRU 4.2.27R</i> .	
retrospective reserve	the <i>premiums</i> paid by the <i>policyholder</i> , less deductions for expenses, tax and other charges, plus allocations of business profits, accumulated at the rate of investment return achieved.	
return	the documents required (taken together) to be deposited under <i>IPRU(INS)</i> rule 9.6(1).	
risk capital margin	the risk capital margin for a <i>with-profits fund</i> calculated in accordance with <i>PRU 7.4.41R</i> to <i>PRU 7.4.96G</i> .	
secured debt	a debt fully secured on:	
	(a)	assets whose value at least equals the amount of debt; or
	(b)	a letter of credit or guarantee from an <i>approved counterparty</i> .
Solvency 1 Directive	the Directive of the European Parliament and of the Council of 5 March 2002 amending Council Directive 79/267/EEC as regards the solvency margin requirements for life assurance undertakings (No 2002/12/EC).	
step-up	(1)	(in relation to a <i>tier one instrument</i>) a step-up has the meaning given in <i>PRU 2.2.74R</i> ; and
	(2)	(in relation to a <i>tier two instrument</i>) step-up has the meaning given in <i>PRU 2.2.118R</i> .
sub-group	(in relation to a <i>person</i>): (a) that <i>person</i> ; and (b) any <i>person</i> that is either; (i) a <i>subsidiary undertaking</i> of that <i>person</i> ; or (ii) an <i>undertaking</i> in which that <i>person</i> or a <i>subsidiary undertaking</i> of that <i>person</i> holds a <i>participation</i> .	

Swiss general insurer	a <i>non-EEA insurer</i> which has its head office in Switzerland and which has <i>permission</i> under the <i>Act</i> to effect or carry out <i>general insurance contracts</i> in accordance with the <i>Swiss Treaty Agreement</i> of 10 October 1989.
Swiss Treaty Agreement	the agreement of the 10 October 1989 between the European Economic Community and the Swiss Confederation on direct insurance other than life insurance, approved on behalf of the European Economic Community by the Council Decision of 20 June 1991 (No. 91/370/EEC).
technical provision	a technical provision as defined in the <i>insurance accounts rules</i> .
tier one capital	an item of capital that is specified in sections A, B or C of the table in <i>PRU 2.2.14R</i> .
tier one capital resources	the sum calculated at stage F of the calculation in <i>PRU 2.2.14R</i> .
tier one instrument	an item of capital that falls into <i>PRU 2.2.27R</i> and is eligible to form part of a <i>firm's tier one capital resources</i> .
tier two capital	an item of capital that is specified in sections G or H of the table in <i>PRU 2.2.14R</i> .
tier two instrument	an item of capital that falls into <i>PRU 2.2.101R</i> or <i>PRU 2.2.108R</i> and is eligible to form part of a <i>firm's tier two capital resources</i> .
tier two capital resources	the sum calculated at stage I of the calculation in <i>PRU 2.2.14R</i> .
total capital resources	the sum calculated at stage M of the calculation in <i>PRU 2.2.14R</i> .
transferable security	an <i>investment</i> within <i>COLL 5.2.7R</i> (<i>transferable securities</i>), <i>CIS 5.2.9R</i> (<i>transferable securities</i>) or, as the case may be, <i>CIS 5A.2.9R</i> (<i>transferable securities</i>) in relation to <i>schemes</i> falling under <i>COLL 5</i> , <i>CIS 5</i> or <i>CIS 5A</i> respectively.
UK-deposit insurer	a <i>non-EEA insurer</i> that has made a deposit in the <i>United Kingdom</i> under article 23 of the <i>First Non-Life Directive</i> in accordance with article 26 of that Directive or under article 51 of the <i>Life Assurance Directive</i> in accordance with article 56 of that Directive.
UK insurer	an <i>insurer</i> , other than a <i>pure reinsurer</i> or a <i>non-directive insurer</i> , whose head office is in the <i>United Kingdom</i> .

PRU Definitions

UK MCR	(in <i>PRU 7.6</i>) <i>MCR</i> calculated by a <i>non- EEA direct insurer</i> (except a <i>UK-deposit insurer</i> , an <i>EEA-deposit insurer</i> or a <i>Swiss general insurer</i>) in relation to business carried on by the firm in the <i>United Kingdom</i> .
ultimate insurance parent undertaking	a <i>parent undertaking</i> that is either an <i>insurance undertaking</i> or an <i>insurance holding company</i> and is not itself the <i>subsidiary undertaking</i> of another <i>insurance parent undertaking</i> .
unearned premium	the amount set aside by a <i>firm</i> at the end of its <i>financial year</i> out of <i>premiums</i> in respect of risks to be borne by the <i>firm</i> after the end of the <i>financial year</i> under <i>contracts of insurance</i> entered into before the end of that year.
unpaid initial fund	part of the <i>initial fund</i> of a <i>mutual</i> which the <i>mutual</i> is prevented from including in its <i>permanent share capital</i> in accordance with <i>PRU 2.2.29R</i> because it is not fully paid.
unsecured debt	<i>debt</i> that does not fall within the definition of <i>secured debt</i> .
upper tier two capital	an item of capital that is specified in section G of the table in <i>PRU 2.2.14R</i> .
upper tier two capital resources	the sum calculated at stage G of the calculation in <i>PRU 2.2.14R</i> .
upper tier two instrument	an item of capital that falls into <i>PRU 2.2.101R</i> and is eligible to form part of a <i>firm's upper tier two capital resources</i> .
with-profits assets	assets that match liabilities in respect of <i>with-profits insurance business</i> or represent a <i>with-profits surplus</i> .
with-profits benefits reserve	the with-profits benefits reserve for the <i>with-profits fund</i> calculated in accordance with <i>PRU 7.4.113R</i> to <i>PRU 7.4.133G</i> .
with-profits fund	a <i>long-term insurance fund</i> (or that part of such a fund) in which <i>policyholders</i> are eligible to participate in any <i>established surplus</i> .
with-profits insurance business	the business of effecting or carrying out <i>with-profits insurance contracts</i> .
with-profits insurance capital component	the capital component for <i>with-profits insurance business</i> of <i>realistic basis life firms</i> calculated in accordance with <i>PRU 7.4</i> .
with-profits insurance contract	a <i>long-term insurance contract</i> which provides for the <i>policyholder</i> to be eligible to participate in any surplus arising on the whole of, or any part of, the <i>insurer's long-term insurance business</i> .

PRU Definitions

<i>with-profits insurance liabilities</i>	liabilities arising from <i>with-profits insurance business</i> .
<i>with-profits surplus</i>	a <i>long-term insurance surplus</i> in which <i>policyholders</i> are eligible to participate (or would have been had it not been carried forward as an unallocated surplus).
<i>WPICC</i>	the <i>with-profits insurance capital component</i> as in <i>PRU 7.4</i> .
<i>written gross premiums</i>	see under ' <i>gross written premiums</i> '.
<i>zillmerising</i>	the method known by that name for modifying the <i>net premium</i> reserve method of valuing a long-term <i>policy</i> by increasing the part of the future <i>premiums</i> for which credit is taken so as to allow for initial expenses.

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