Consultation Paper

06/12**

Financial Services Authority

Implementing the Reinsurance Directive

June 2006

FSA®

Contents

The Financial Services Authority invites comments on this Consultation Paper. Comments should reach us by 20 August 2006.

Comments may be sent by electronic submission using the form on the FSA's website at (www.fsa.gov.uk/pubs/cp/cp06_12_response.html).

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1 Overview

1.1. The EU Reinsurance Directive (RID) came into force on 10 December 2005 and must be implemented across the EU by 10 December 2007. Until now, there have been no EU directives specifically relating to the prudential supervision of reinsurance business, although in the UK we have broadly carried over the requirements of the existing direct insurance directives to reinsurers. This Consultation Paper (CP) sets out our proposals for implementing the RID.

1.2. In this chapter we describe what the RID does, our overall approach to implementation, our main proposals and the firms that will be affected by them. Although the RID is primarily concerned with the regulation of pure reinsurers (firms that only carry out reinsurance business), some of the changes we are proposing will also affect direct insurers. We also outline our proposal to allow Insurance Special Purpose Vehicles (ISPVs) to be established.

What the RID does

1.3. The RID is an interim measure that introduces a minimum level of harmonised prudential supervision of reinsurance across the EU, in advance of a wider directive that will apply to all insurers, known as Solvency 2. The Commission intends to create a single European market in reinsurance and remove remaining barriers to trade within the EU that arise from the existence of varied supervisory regimes across Member States. Under the RID, each reinsurer will be supervised by the competent authority in its home state and will be able to operate throughout the EU on that basis. The RID also allows Member States the option to establish an ISPV market. We intend to introduce a fit-for-purpose regime for authorising and regulating ISPVs.

Firms affected by our proposals

1.4. The overall effect of the RID is limited for most UK reinsurers, as they are already required to meet similar rules, but three sets of firms will be affected in various ways by the proposals described in this paper:

- pure reinsurers: firms that only write reinsurance business, including captive reinsurers that only accept business from a single firm;
- mixed insurers: this is a new classification of firms, covering direct insurers that also write a significant amount of reinsurance business[1]; and
- direct insurers: our proposals for ISPVs and the principles we propose for financial reinsurance may have an impact on the way insurers use reinsurance to mitigate risk. The RID has retained the current exemption for non-directive friendly societies, as set out in the Life Assurance and Non-Life Directives.

Minimum implementation

1.5. Implementing the RID will necessitate relatively few changes to the current UK regime applying to reinsurance. Accordingly, rather than recasting present requirements completely we intend to make the minimum changes needed in each context. Although we are not proceeding via 'copy-out' of the Directive text (which you can access via europa.eu.int/eur-lex/lex/LexUriServ/site/en/oj/2005/l_323/l_32320051209en00010050.pdf) wherever practical our proposals avoid super-equivalence.

1.6. We are consulting on this basis as we believe it is more appropriate for us to rely, in general, on our more risk-based and responsive Individual Capital Adequacy Standards (ICAS) than to impose additional, prescriptive requirements on firms conducting reinsurance business. We expect the overall impact of this approach will include a reduction in the Pillar 1 capital requirements and technical provisions for long-term reinsurance protection business. However, the capital a firm is required to hold will continue to be subject to an Individual Capital Assessment (ICA) and Individual Capital Guidance (ICG).

Our proposals

1.7. Our current regulation of reinsurance business is based on the existing Life Assurance and Non-Life Directives. Although the RID is based on the same directives, there are differences that allow us to reduce our existing requirements for reinsurance where they are in excess of the RID requirements. Such simplifications are proposed in the areas described in paragraphs 1.8 to 1.15 below.

Prudent person investment principles (Chapter 2)

1.8. The RID requires us to introduce five prudent person investment principles (set out in the Directive), which are intended to ensure sufficient liquidity, security, quality, profitability and matching of assets for pure reinsurers. In line with our move to principles-based regulation, we propose to remove all other restrictions on pure

1 The RID defines a mixed insurer as a direct insurer that also does reinsurance business where the reinsurance premiums collected exceed 10% of total premiums, or reinsurance premiums collected exceed €50m, or technical provisions resulting from reinsurance acceptances exceed 10% of total technical provisions.

reinsurers' choice of assets, including our existing list of admissible assets and all quantitative investment limits.

Changes to the capital requirements and technical provisions (Chapter 2)

1.9. In line with the RID, we propose to change the Pillar 1 capital requirement for life protection business, written by either pure reinsurers or mixed insurers, by calculating the requirements using a non-life basis (based on premiums and claims over a specified period) instead of using the existing Life Assurance Directive basis. This would allow both pure reinsurers and mixed firms the benefit of the minimum capital requirements under the RID. Our risk-based ICAS regime will continue to ensure that firms maintain sufficient capital to a level at least as strong as a 99.5% confidence level over one year.

1.10. We also propose to remove certain specific rules for determining the technical provisions relating to pure reinsurers' long-term insurance protection business. In this respect, the approach for reinsurance protection business differs from the current approach to technical provisions for direct writers.

1.11. From our preliminary discussions with firms, we expect UK pure reinsurers to realise an aggregate increase in excess capital of approximately £730m, from £580m to £1,310m as a result of our proposals.

Relaxing restrictions on reinsurers' activities (Chapter 2)

1.12. We propose to relax our existing restrictions on pure reinsurers' activities to allow them to carry out 'related operations' in addition to their core business. These could include provision of additional services such as actuarial advice or claims management services.

Insurance Special Purpose Vehicles (Chapter 3)

1.13. The RID enables Member States that wish to introduce an Insurance Special Purpose Vehicle (ISPV) market to establish a new regime, of defined scope, for their authorisation and regulation. We propose to introduce a fit-for-purpose regime for ISPVs with reduced authorisation requirements compared with those required for insurance companies. We believe that our proposals would encourage greater participation in the ISPV market, as an ISPV would no longer have to go through the full authorisation process that generally applies to reinsurers.

Principles for financial reinsurance (Chapter 4)

1.14. To ensure that appropriate standards are maintained, we also propose that any reduction in regulatory Pillar 1 capital under a financial reinsurance contract should be no greater than is justified by the reduction in risk. Effective risk transfer is required. We believe that this approach will encourage innovative transactions that truly transfer risks to the capital markets and propose that these principles should also apply to ISPVs.

Insurance groups and financial conglomerates (Chapter 5)

1.15. This chapter applies to groups that consist entirely of reinsurance entities, and insurance groups whose members include reinsurance entities. Under our existing rules, reinsurers are brought into adjusted solo and insurance group calculations by applying the requirements from the Life Assurance and Non-Life Directives and the Insurance Groups Directives (IGD). We propose to apply the RID requirements set out in this CP to reinsurers when group calculations (adjusted solo and insurance groups calculations) are performed. This will allow insurance groups to benefit from our proposed implementation at the group and solo level.

Pre-consultation with the industry

1.16. Since the RID was adopted in November 2005, we have continued to work with the UK reinsurance industry through trade associations, by making papers discussed at our Insurance Standing Group available on our website at www.fsa.gov.uk/Pages/About/What/International/solvency/isg/index.shtml and through bilateral discussions with reinsurers. We appreciate the constructive and collaborative contribution of all participants in this process.

Next steps for implementation

1.17. In our Business Plan for 2006/07, we announced that we would be consulting on the implementation of the RID during the third quarter of 2006. We have brought this consultation forward to June and, following discussions with the industry, we have decided to shorten the period for responses to two months, so our final rules can be in place for December 2006. This will enable firms to benefit from our proposed rule changes as at 31 December 2006 for year-end reporting purposes.

1.18. While this CP contains the bulk of our proposals for implementing the RID, it does not include provisions to enable reinsurers authorised in another Member State to passport into the UK. This requires HM Treasury (the Treasury) to make changes to the Financial Services and Markets Act 2000 (FSMA). Further amendments to FSMA, and regulations made under it, will also be required to implement the RID conditions for an insurance business transfer and other elements of the directive related to consultation with the competent authorities of other Member States. These aspects of the implementation will be subject to a separate consultation by the Treasury, expected in Autumn 2006.

Structure of this paper

1.19. This CP sets out the proposals described above in more detail, and asks for responses in a number of areas. In Chapter 6 we set out some consequential changes that would be needed to the insurance annual return (the FSA returns).

1.20. The proposed changes to our rules and guidance are in a draft instrument at Appendix 1. This follows the structure of the proposed new Prudential Sourcebooks, namely the Insurance Prudential Sourcebook (INSPRU) and the General Prudential Sourcebook (GENPRU)[2]. These were consulted on in CP06/10, CP06/03 and CP05/03[3].

How our proposals affect consumers:

The implementation of the RID is unlikely to affect consumers or consumer groups directly as it deals with the prudential regulation of reinsurance, an activity that is by nature a business-to-business transaction in the wholesale market. Nonetheless, the prudential regulation of reinsurance has an effect on consumers because the ability of direct insurers to meet policyholder claims can be at least partially dependent on the financial security of their reinsurers. Pricing in the reinsurance market will also tend to influence insurance premiums paid by consumers.

2 IPRU(INS) has not been updated to take account of the development of GENPRU and INSPRU, with the result that cross-references to prudential rules in Annex F of the draft instrument continue to be to PRU.

3 CP06/10 Strengthening Capital Standards – Restructuring the Handbook (May 2006), CP06/03 Strengthening Capital Standards 2 (February 2006) and CP05/03 Strengthening Capital Standards (January 2005).

2 Proposals affecting life and non-life reinsurance business

Summary

2.1. This chapter sets out our proposals to:

- introduce the RID ‘prudent person’ investment principles;
- change the capital requirements and the calculation of technical provisions for long-term reinsurance protection business;
- make relatively minor changes to the components of the non-life reinsurance solvency margin;
- relax the restrictions on the operations of pure reinsurers to include ‘related operations’ in addition to their core business; and
- align pure reinsurers’ Base Capital Resources Requirement with that of direct insurers.

2.2. The changes would affect all pure reinsurers and the change in capital requirements for long-term reinsurance protection business would also apply to the reinsurance business of mixed insurers.

Clarifying the application of our requirements for capital resources and technical provisions to non-EEA insurers

2.3. To clarify and better reflect our existing policy intention for non-EEA insurers, we propose to amend certain rules - INSPRU 1.1.3R to INSPRU 1.1.5R. In particular INSPRU 1.1.3R makes it clear that if the UK business of a non-EEA insurer (other than an EEA deposit insurer, a Swiss general insurer or a UK-deposit insurer) is not restricted to reinsurance then certain requirements for capital resources and technical provisions (INSPRU 1) apply separately for worldwide and branch activities. If the UK business is restricted to reinsurance, then under INSPRU 1.1.2R, our requirements apply only to worldwide activities.

2.4. We believe this accurately reflects current practice in firms and we invite the industry to inform us if this is not the case.

Introduction of 'prudent person' investment principles

2.5. The RID requires that we do not use detailed rules to restrict the assets that pure reinsurers (both life and non-life) can hold, but instead requires us to put in place a set of five 'prudent person' investment principles which are intended to ensure sufficient liquidity, security, quality, profitability and matching of assets. This means we must remove the existing admissible asset rules and quantitative limits for pure reinsurers. In addition to the five investment principles, the RID sets out three optional quantitative limits that can be applied where they are prudentially justified. These are that:

- investments of gross technical provisions in currencies other than those in which technical provisions are set should be limited to 30%;
- investments of gross technical provisions in shares and other negotiable securities treated as shares, bonds and debt securities which are not admitted to trading on a regulated market should be limited to 30%; and
- no more than 5% of gross technical provisions is invested in shares and other negotiable securities treated as shares, bonds, debt securities and other money and capital market instruments from the same undertaking, and no more than 10% of total gross technical provisions is invested in shares and other negotiable securities treated as shares, bonds, debt securities and other money and capital market instruments from undertakings which are members of the same group.

2.6. We think these quantitative limits would place unnecessary constraints on pure reinsurers' investment strategies, so we do not consider the additional restrictions necessary.

2.7. The RID also provides Member States with the option to extend the prudent person principles to the reinsurance business of mixed insurers. As this option cannot be implemented on a firm-by-firm basis, all mixed insurers would be required to comply with the principles and associated ring-fencing conditions specified in the directive. Following discussion with the industry, we have decided not to extend this option to mixed insurers, given the relatively marginal benefit to mixed insurers that would be likely to arise from moving to the RID principles. This is due to the ring-fencing requirements which would be too burdensome for firms in terms of setting up new systems and operating processes.

Proposal

2.8. Our current rules require that all insurance and reinsurance firms hold admissible assets to cover their technical provisions, other liabilities and capital resource requirements, and do not exceed certain quantitative limits. Under the RID we are required to remove our existing list of admissible assets and quantitative limits for pure reinsurers (both life and non-life). Instead, pure reinsurers will be required to invest their assets in line with the principles set out in the RID as outlined below in Box 1 (which are included, at INSPRU 3.1.61A, in Appendix 1).

Box 1: RID Article 34(1)

a) assets shall take account of the type of business carried out by a reinsurance undertaking, in particular the nature, amount and duration of the expected claims payments, in such a way as to secure the sufficiency, liquidity, security, quality, profitability and matching of its investments;

b) the reinsurance undertaking shall ensure that the assets are diversified and adequately spread and allow the undertaking to respond adequately to changing economic circumstances, in particular developments in the financial markets and real estate markets or major catastrophic events. The undertaking shall assess the impact of irregular market circumstances on its assets and shall diversify the assets in such a way as to reduce such impact;

c) investment in assets which are not admitted to trading on a regulated financial market shall in any event be kept to prudent levels;

d) investment in derivative instruments shall be possible insofar as they contribute to a reduction of investment risks or facilitate efficient portfolio management. They shall be valued on a prudent basis, taking into account the underlying assets, and included in the valuation of the institution's assets. The institution shall also avoid excessive risk exposure to a single counterparty and to other derivative operations; and

e) the assets shall be properly diversified in such a way as to avoid excessive reliance on any one particular asset, issuer or group of undertakings and accumulations of risk in the portfolio as a whole. Investments in assets issued by the same issuer or by issuers belonging to the same group shall not expose the undertaking to excessive risk concentration.

Member States may decide not to apply the requirements referred to in point (e) to investment in government bonds.

2.9. In recognition of the high level of security afforded by investment in government bonds, we propose to introduce the optional exemption (set out in Box 1 above) from the diversification principle (e). Under our proposals principle (a) will still apply in respect of these investments to ensure the sufficiency, liquidity, security, quality, profitability and matching of investments in government bonds.

2.10. We do not propose to retain any other restrictions on pure reinsurers' investment decisions. This is compatible with our move towards principles-based regulation and consistent with our view that firms should take responsibility for their investment strategy. The impact of a firm's investment strategy on its risk-based capital requirement would be seen through its ICA and monitored by us through the supervisory review process.

2.11. Taking into consideration the feedback we have received from the industry, we do not propose to extend the RID prudent person principles to the reinsurance business of mixed insurers.

Q1: Do you agree with our minimal approach to implementing the prudent person, principles-based rules for reinsurance business?

Q2: Do you agree with our proposal not to implement the prudent person principles and associated ring fencing requirements for mixed insurers' reinsurance business?

Changes to the life reinsurance solvency margin

2.12. The RID allows us to calculate the Pillar 1 capital requirement on a non-life basis for life reinsurance protection business (long-term insurance Class I reinsurance business that is not annuity or participating business and is not linked to investment funds) written by pure reinsurers and mixed insurers. We have estimated that this approach would lead, on average, to a capital requirement for life protection business that is approximately 50% lower than the existing UK basis. The Life Assurance Directive applies the non-life calculation to all Permanent Health Insurance (PHI) business but has also retained an additional 4% capital charge for expenses and market risk. Under the RID we can remove the 4% charge for PHI business reinsured by pure reinsurers and mixed insurers, which we estimate will reduce the capital requirement for this business by approximately 45% on average.

Life investment and annuity business

2.13. For investment and annuity business, the RID allows us to either move to the non-life test, or to continue to require pure life reinsurers and mixed insurers to hold a solvency requirement based on the Life Assurance Directive (which we currently modify to give credit to pure reinsurers for up to 50% of retrocessions).

2.14. In contrast to life protection business, for investment and annuity business, the non-life solvency rules would, in general, be more onerous than the life requirements. They are also less risk sensitive and so less appropriate as a measure of capital requirements. This is particularly likely to be the case for large single premium annuity contracts, where there is a large premium in the first year but no further premiums in later years. This is because the non-life test is calculated on the basis of premiums and claims over a specified period, which are not appropriate proxies for the risk under this type of contract. For these reasons we intend to maintain the existing life solvency requirements for pure reinsurers and mixed insurers in this area.

Proposals

2.15. In line with the RID, we propose to allow the use of the non-life solvency test for life reinsurance protection and PHI business reinsured by pure reinsurers and mixed insurers. We expect the non-life requirement to reduce the capital requirements to approximately 0.05% of capital at risk. We expect this to result in an aggregate reduction in the Pillar 1 life capital requirements for pure reinsurers' long-term protection reinsurance business of approximately 50% (£280m). The reduced requirement would give effect to the minimum directive requirement and should enable UK reinsurers to be more competitive. Capital adequacy will be maintained as the level of capital a firm must hold is subject to a minimum of the capital required under each firm's ICA. The ICA requirement will ensure that each firm holds sufficient capital to a level at least as strong as a 99.5% confidence level over one year.

2.16. For the reasons set out in paragraph 2.14 we propose to maintain the existing life solvency requirements for pure reinsurers and mixed insurers investment and annuity life business.

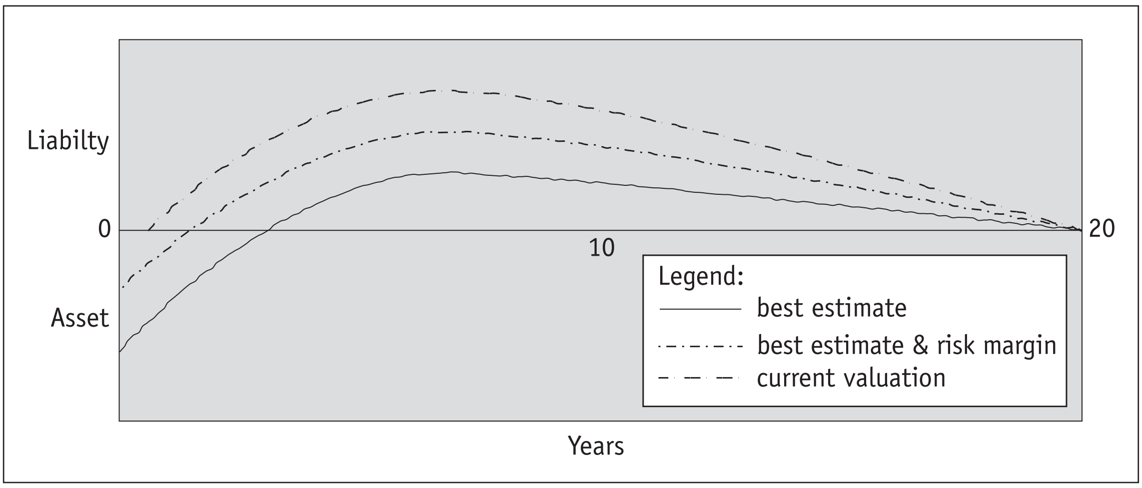
> Q3: Do you agree with the proposal to use the non-life solvency margin for the long-term life protection reinsurance business of pure reinsurers and mixed insurers?
>
> Q4: Do you agree that we should not extend the non-life solvency rules to investment and annuity business?

Changes to the calculation of life technical provisions

2.17. To ensure that technical provisions are calculated in a prudent way, the Life Assurance Directive and our Handbook contain a number of specific rules. We believe that the Life Assurance Directive rules ensure firms hold an adequate level of technical provisions for investment and annuity business. But they can impose substantial margins over the best estimate result for long term reinsurance protection business. The RID gives us the option to apply the less specific Non-Life Directive requirement to the calculation of technical provisions for life reinsurance business. This allows us to remove certain specific rules for pure reinsurers' protection and PHI business where we believe they are overly prudent.

2.18. The diagram below provides a simple example of the development of technical provisions over the term of a typical level term assurance policy on three different bases:

Development of technical provision for 20-year level term contract



2.19. We now provide a brief explanation describing each approach.

2.20. **Current valuation** (pure reinsurers and direct writers)**:** currently our rules require each assumption to be set equal to the best estimate plus a risk margin where the margin is greater than or equal to the relevant market price for that risk. In addition, as a further prudential margin, our current rules allow no lapses to be assumed if this would reduce the amount of the technical provisions. Furthermore, the current valuation approach does not allow a contract to be treated as an asset. We consider that, given the focus on the ICAS risk-based capital adequacy test, the current valuation approach is unnecessarily prudent and thereby locks in capital so it cannot be used to greatest efficiency.

2.21. **Best estimate:** on this basis all assumptions are on a best estimate basis, including future lapse rates. Where appropriate, a contract may be treated as an asset. This arises where the value of future premiums exceeds the value of future claims and other costs, usually within the early years that a contract is in-force. This approach could result from applying general accounting principles (GAAP) applicable to non-life business. However, the assumptions do not contain any risk margins and this makes it more likely that technical provisions calculated using this approach might be insufficient to enable a third party to assume the liabilities or recapitalise the business.

2.22. **Best estimate plus risk margin:** this approach is consistent with proposals for Solvency 2. Each assumption, including lapse rates, is set equal to the best estimate plus a risk margin where the margin would be greater than or equal to the relevant market price for that risk. The method permits a policy to be valued as an asset, a lapse rate assumption would also be allowed, and in these two respects this approach would differ from the current approach to technical provisions. This method would also be broadly consistent with applying the principles of the Non-Life Directives to this class of business. The approach would generate technical provisions that should be sufficient to enable reinsurers to transfer their life protection liabilities to a third party if necessary, or to recapitalise the business, so this is our recommended valuation method.

Proposal

2.23. Our proposed approach is therefore to adopt the best estimate plus a risk margin approach to set the technical provisions for pure reinsurers' protection and PHI business. Technical provisions should be set so they enable reinsurers to transfer their life protection liabilities to a third party if necessary or to recapitalise the business. This would permit a policy to be valued as an asset and a lapse rate assumption would also be allowed. For long-term protection (long term insurance Class I business that is not annuity or participating business and is not linked to investment funds and Permanent Health Insurance business), this would release approximately £710m of reserves, an average reduction of approximately 30% in mathematical reserves for the UK's pure life reinsurers.

2.24. By moving pure reinsurers onto a lower basis, an increase in the volume of long-term protection business reinsured by direct writers (through captive or external pure reinsurers) may occur.

2.25. We expect the combined effect of our proposals for capital requirements and technical provisions to result in an aggregate increase in excess capital for the UK's pure reinsurers of approximately £730m, from £580m to approximately £1,310m. Our rules require that firms hold the higher of their Pillar 1 capital and our ICAS (Pillar 2) requirement. In some instances, the extent to which a firm can realise its Pillar 1 capital reductions is limited by the ICAS requirement and also because of any additional tax liability arising from the release of reserves.

2.26. Further, where protection contracts that are being treated as assets are used to back liabilities arising from other business, firms will need to take account of the matching of investments. In line with the prudent person investment principles set out in Box 1, firms will need to consider the characteristics of the protection contracts as assets (e.g. liquidity, cash flow matching etc.) to ensure they provide an appropriate match for the liabilities.

> Q5: Do you agree that in setting the technical provisions for pure reinsurers' protection and PHI business, we should use a best estimate plus risk margin approach?

Changes affecting non-life pure reinsurers

2.27. There are very few policy changes that are specific to non-life business as the RID is primarily based on the Non-Life Directives for direct insurance business, which we have already applied to pure reinsurers in the UK. However, two changes are required where we have previously not applied certain parts of the insurance rules to pure reinsurers but are now required to do so by the RID. Firstly the requirement to add back discounting when calculating technical provisions and secondly, the requirement to hold credit equalisation provisions. We do not propose to require EEA pure reinsurers whose head office is not in the UK to meet these requirements as long as they exercise EEA Passporting or Treaty Rights before 10 December 2008, at which point the rules applicable in their home Member State will apply.

Requirement to add back discounting

2.28. For direct non-life insurers we do not allow discounting of technical provisions in the calculation of the Pillar 1 capital requirement. However, currently non-life pure reinsurers in the UK have an exemption from this requirement and are allowed to reduce their technical provisions by discounting in this calculation.

2.29. The RID requires that, in common with direct non-life insurance firms, non-life pure reinsurers add back any discounting of technical provisions for claims outstanding before calculating the total Pillar 1 capital requirement. We understand that very few UK non-life pure reinsurers currently make use of this exemption and so we do not expect the impact on most firms' net asset position to be significant. This Directive requirement will bring the treatment of pure reinsurers into line with the EU rules for non-life insurers.

Requirement to hold credit equalisation provisions

2.30. The Non-Life Directives require direct insurers to hold credit equalisation provisions, but we do not currently extend this requirement to non-life pure reinsurers in the UK. The RID requires us to extend this requirement to pure reinsurers who will have to include credit equalisation provisions as a liability in future. However, we do not expect this to have a significant impact on the UK's non-life pure reinsurers.

2.31. We will not be applying these changes to reinsurers that are in run-off before the implementation of our rules as at 31 December 2006. This is because such firms only have a finite amount of capital and cannot easily find more.

Allowing pure reinsurers to carry out 'related operations' in addition to their core business

2.32. Our current rules do not allow a pure reinsurer to carry out activities that do not directly arise from the insurance business it undertakes. This means that UK firms generally set up service subsidiaries to enable them to offer other services to their clients.

2.33. The RID gives us the flexibility to relax this requirement so that pure reinsurers can carry out related operations. These might include providing statistical or actuarial advice, risk analysis or research for clients. However, the RID does not allow the carrying on of unrelated banking and financial activities.

Proposal

2.34. We propose relaxing our existing restrictions on the activities that pure reinsurers can carry on to include related operations in addition to conducting reinsurance business. We consider that this could reduce firms' costs associated with maintaining additional service subsidiaries.

> Q6: Do you agree that we should relax our existing restrictions on reinsurers' activities to include related operations in addition to conducting reinsurance?

Results of the European Commission's review of the Base Capital Resources Requirement (BCRR)

2.35. The Commission recently carried out its annual inflation review of the BCRR (the minimum guarantee fund that an insurer must hold) as set out in the Life Assurance and Non-Life Directives. As a result, the minimum capital requirements in the Directives have been increased as follows and we will be amending GENPRU to reflect the changes:

- liability insurer – directive mutual – €2.4m;
- liability insurer – other – €3.2m;
- other general insurer – directive mutual – €1.65m;
- other general insurer – other – €2.2m;

- long-term insurer – directive mutual – €2.4m; and
- long-term insurer – other – €3.2m.

2.36. In addition, the premiums index in INSPRU 1.1.45 will increase from €50m to €53.1m and the claims index in INSPRU 1.1.47 from €35m to €37.2m.

Updating the RID BCRR

2.37. The provision for the carrying out of the Commission's annual inflation review of the BCRR set out in the Life Assurance and Non-Life Directives was copied across to the RID. But as the RID was not in force when the review was carried out, the amount of the BCRR for pure reinsurers and captives and the relevant premiums and claims indices were not increased.

Proposal

2.38. In line with the RID we will be introducing a single BCRR for pure reinsurers non-life and life reinsurance activities. We also propose to increase the amounts of the BCRR and premiums and claims indices set out in the RID to reflect the outcome of the Commissions review. This is consistent with the Life Assurance and Non-Life Directives, although the indexation of the premiums and claims index is not an RID requirement.

2.39. Our proposed approach would mean the BCRR for pure reinsurers increased from €3m to €3.2m and the premiums and claims indices increased from €50m to €53.1m and €35m to €37.2m respectively. This will secure a level playing field between insurers writing reinsurance business and pure reinsurers.

2.40. We also propose to amend our rules, so any changes to the BCRR and premiums and claims indices due to the Commission's review will be implemented by amending the relevant amounts as they appear in our rules. This is as opposed to automatic increases being notified through our website. This will make the revised values and the date they come into force clearer.

Q7: Do you agree that we should align the BCRR for pure reinsurers with that for direct insurers?

3 Insurance Special Purpose Vehicles

3.1. The RID gives Member States that want to encourage the development of a market for Insurance Special Purpose Vehicles (ISPVs) in their jurisdiction the option to introduce a separate fit-for-purpose authorisation and supervisory regime covering:

- authorisation and solvency requirements;
- when amounts due from the ISPV can be counted as admissible assets; and
- when amounts due from the ISPV can be counted as reinsurance or retrocession in order to reduce the ceding firm's solvency requirements.

Options

3.2. Currently in the UK ISPVs must apply for authorisation as a reinsurer and are regulated as such. The RID allows us to either maintain this arrangement or to create a new regime for the authorisation and regulation of ISPVs.

3.3. Over the last few years we have seen a number of insurance securitisations. Preconsultation discussions with the industry have indicated there are two main factors determining the location of these innovative vehicles, namely the regulatory and fiscal regimes in the jurisdiction. In addition to our proposals set out below, on 13 June 2006, HM Revenue and Customs (HMRC) proposed the implementation of a new taxation regime for Special Purpose Vehicles involved in the securitisation of financial assets, to take effect from 1 January 2007, and issued a set of draft regulations. The proposals are available on HMRC's website www.hmrc.gov.uk/practitioners/int_accounting.htm#sec. As part of their proposals, HMRC are seeking industry views on whether ISPVs should also be brought within the scope of that regime. HMRC have set a deadline of 6th July 2006 to receive industry views regarding their taxation proposals.

Proposal

3.4. With those points in mind, we propose to introduce a fit-for-purpose regime for ISPVs with authorisation and prudential requirements that are proportionate to the risks. This would require ISPVs to provide less information than insurers or reinsurers to get authorised and our supervision would be focused on the ceding firm's risk management and how that is reflected in its ICA. If we introduce a regime for ISPVs the RID requires us to bring in several rules for ISPVs. These requirements are outlined in the extract from RID Article 46 below (Box 2).

Box 2: RID Article 46 – Special purpose vehicles

1. Where a Member State decides to allow the establishment within its territory of special purpose vehicles within the meaning of this directive, it shall require prior official authorisation thereof.
2. The Member State where the special purpose vehicle is established shall lay down the conditions under which the activities of such an undertaking shall be carried on. In particular, that Member State shall lay down rules regarding:

- scope of authorisation;
- mandatory conditions for inclusion in all contracts issued;
- the good repute and appropriate professional qualifications of persons running the special purpose vehicle;
- fit and proper requirements for shareholders or members having a qualifying holding in the special purpose vehicle;
- sound administrative and accounting procedures, adequate internal control mechanisms and risk management requirements;
- accounting, prudential and statistical information requirements; and
- the solvency requirements of special purpose vehicles.

3.5. Any ISPV regime we propose must meet these requirements. We now outline our proposal to establish a fit-for-purpose regime for ISPVs in the UK.

Defining an ISPV

3.6. An ISPV must meet the RID definition which states that an ISPV is:

> 'any undertaking, whether incorporated or not, other than an existing insurance or reinsurance undertaking, which assumes risks from insurance or reinsurance undertakings and which fully funds its exposure to such risks through the proceeds of a debt issuance or some other financing mechanism where the repayment rights of the providers of such debt or other financing mechanism are subordinated to the reinsurance obligations of such a vehicle;'[4]

4 RID Article 2(1)(p) – Definitions, 'special purpose vehicle'.

3.7. We believe fully funded means that the ISPV's reinsurance liabilities must be capped at the value of the assets available to fund those liabilities. The assets and liabilities of the ISPV will be subject to the same prudent person investment principles set out in Chapter 2 and must be valued according to GAAP conventions. As required by the RID, the ISPV must be funded through the proceeds of a debt issuance or other financing mechanism that brings additional capital into the management of the insurance risks. The assets must be held by or on behalf of the ISPV or the ceding firm to ensure adequate security of the assets, and the repayment rights of the finance providers must be subordinated to the reinsurance obligations of the ISPV.

Minimal authorisation requirements

3.8. To comply with the RID, an ISPV established in the UK must be authorised. We propose to facilitate the development of a UK market for ISPVs by ensuring the authorisation requirements are proportionate to the risks, with less information expected from an ISPV than from a traditional insurer or reinsurer, with greater emphasis on self-certification. We intend to ensure that appropriate safeguards to protect insurance company policyholders are maintained. This will be achieved by placing the onus on the ceding firm to provide further information on the impact of the ISPV on its ICA. It must do this before the amounts recoverable from an ISPV can count towards its technical provisions or its capital requirements. This is consistent with our risk-based approach to authorisation and reflects the low risk of failure that should arise from a properly structured ISPV. The ceding firm must ensure the arrangement is legally sound and that all associated risks, including insurance, credit, market, liquidity and operational risks, are assessed and included in its ICA.

3.9. We propose developing a fit-for-purpose authorisation regime within the existing scope of FSMA by authorising an ISPV as a reinsurer with a requirement restricting it to the activities of an ISPV. We propose to adapt the existing application form for insurance firms to require the following information from ISPVs. This will provide evidence of compliance with the FSMA threshold conditions and the RID requirement to lay down rules regarding '*sound administrative and accounting procedures, adequate internal control mechanisms and risk management requirements*'. The authorisation would require a:

- Core details form, including: contact details (e.g. solicitor, auditor, legal adviser); legal status (FSMA requires an insurer to be a body corporate – the shares of which may be held by a trust, registered friendly society or a member of Lloyds); group structure; governing body; and business profile (including a requirement restricting it to the activities of an ISPV).

- Business plan, including:

  a) a description of the ISPV's purpose, the risks to be covered and its structure and accountabilities;

  b) financial projections which should demonstrate that the ISPV will be fully funded so that assets (on a GAAP (GENPRU1.3.) basis) are equal to or greater than, the liabilities under all reasonably foreseeable scenarios, taking into account operating costs (adequacy of the opening balance sheet position to be confirmed by management and auditors following completion of the transaction);

c) independent legal confirmation that the agreements surrounding the operation of the ISPV are legally effective. In particular, the agreements must ensure that the repayment rights of debt holders are subordinated to the ISPV's reinsurance obligations;

d) evidence of adequate systems and internal controls (apportionment of management responsibilities, details of arrangements for core functions, compliance monitoring arrangements and claims-handling). We expect that these functions will generally be outsourced by the ISPV and the application should include details of related third party agreements; and

e) where future new business is to be included in an ISPV, the extent of the commitment must be set out transparently at the time of seeking authorisation. We would expect full details of the types of risks the ISPV would receive in the future together with an indication of expected volumes and timescales and information about the limits that would apply.

- Controllers form, requiring information about the persons controlling the ISPV. Where the ISPV is owned by a trust, this would include the trustees and the trust notification form should be completed. This is intended to evidence that the ISPV meets the RID requirement regarding '*fit and proper requirements for shareholders or members having a qualifying holding in the ISPV*'.

- Approved Persons application to be completed which outlines the controlled functions under the approved person's regime. We expect ISPVs to require a small number of controlled functions, including a Chief Executive Officer (CEO) and Director, who will need to be approved. This requirement should not be too onerous, especially as the ceding firm will be familiar with the existing approved persons regime. This is intended to evidence that the ISPV meets the RID requirement regarding '*the good repute and appropriate professional qualifications of the persons running the ISPV*'.

3.10. We propose to be relatively flexible about the ownership structure of an ISPV as we consider ICAS should be able to identify any related increases in counterparty, credit or contagion risks, allowing any potential detriment to policyholders to be identified. For example, where an ISPV is a subsidiary within the ceding firm's group, any additional risk this poses to the group would be reflected in ICAS.

3.11. Once all the required information has been provided we would expect the authorisation process to be relatively short as we intend to rely principally on the opinions provided by the auditors (adequacy of opening balance sheet) and legal advisers (legally effective) before authorising the ISPV. Further validation, as set out in paragraph 3.22, is envisaged where a UK-authorised insurer or reinsurer (the ceding firm) wants to take credit for an ISPV against its capital requirements or on its balance sheet.

3.12. Standard one-off application fees are currently charged at three levels for straightforward applications (£1,000), moderately complex applications (£5,000) and complex applications (£25,000). We intend to consult on the substantive rule changes to implement this proposal in the July 2006 Quarterly CP (QCP). In addition, the July QCP will cover the periodic fees issues outlined in the next paragraph.

Annual periodic fees for ISPVs:

3.13. We also need to develop a suitable periodic fee regime for ISPVs. This would cover:

- the allocation of ISPVs to appropriate fee-blocks;
- a suitable tariff base for measuring ISPVs' contributions to the Annual Funding Requirement we must recover from the fee-block(s); and
- the amount they may be expected to contribute towards periodic fees once they become authorised.

3.14. Our initial view is to combine ISPVs with general and life insurers in the relevant existing fee-blocks (A.3 for general insurers and A.4 for life insurers)[5]. This would accord with our principle of grouping together fee payers with similar permissions.

3.15. The tariff bases for the A.3 and A.4 fee-blocks are based on premiums written and total technical provisions, so we would need to find a suitable fee metric for ISPVs. In common with proposed Handbook changes for a suitable application fee, we intend to consult on the substantive rule changes for ISPV fee-blocks and the periodic fee tariff base together with some other fees issues, in the July 2006 QCP. Proposed fee rates for the 2007/08 financial year will be set out in our annual fees consultation, which we expect to publish in the first quarter of 2007.

3.16. We propose that, in line with our current approach to reinsurance contracts, ISPVs will be excluded from the Financial Services Compensation Scheme (FSCS) and the Financial Ombudsman Service (FOS).

A simple solvency rule

3.17. The RID requires us to lay down rules regarding '*the solvency requirements of ISPVs*'. We propose the introduction of a simple solvency rule for ISPVs, requiring that assets must always be greater than or equal to liabilities. In addition, we propose that the assets of the ISPV must either be retained within the ISPV or the ceding firm. We consider that a more substantial solvency margin requirement (similar to those for direct insurers in INSPRU) is not required as the ISPV's liabilities are, by nature, limited to its total assets with any residual risk retained by the ceding firm as evidenced through its ICA. We propose that only this simple solvency rule, and associated asset and liability valuation requirements contained in GENPRU 1.3. will apply to ISPVs.

3.18. The notification requirements in our existing supervision manual (SUP) will ensure that ISPVs have to notify us if the solvency rule is breached, in which case our rules require the reduced coverage to be reflected in the ceding firm's regulatory balance sheet and ICA, and we would also be able to take supervisory action. The ISPV's

5 FEES 4, Annex 1R, Activity groups, tariff bases and valuation dates.

statutory accounts will allow us to assess continuing compliance and we propose that no additional reporting, with the exception of standing data (name and address type information) updates, will normally be required (i.e. IPRU(INS) will not apply). This will also enable us to meet the RID requirement to lay down rules regarding '*accounting, prudential and statistical information requirements*'.

Who will supervise ISPVs and how?

3.19. To avoid unnecessary burden on firms and our supervisors, and to minimise duplication of effort, we propose that the continuing monitoring of ISPVs will be largely covered through the supervision of the ceding insurer and all residual risks reflected through its ICA. The authorisation process will treat ISPVs being set up in the UK by entities supervised outside the UK in the same way as ISPVs accepting risks from UK-supervised cedants. Under the RID, where the cedant is a non-UK insurer, the home state supervisor will be responsible for supervising the effect of the ISPV on the ceding firm. If a UK-regulated firm establishes an ISPV in another Member State and wishes to take credit for that ISPV in its regulatory balance sheet, while we will not have to re-authorise the ISPV, it will nonetheless be required to meet the same conditions that we are applying to UK-based ISPVs.

Other handbook requirements

3.20. In addition to our proposals for prudential regulation, we propose that ISPVs should be subject to relevant provisions of our 'systems and controls sourcebook' (SYSC), the 'fit and proper test for approved persons' (FIT) and the 'statement of principle and code of practice for approved persons' (APER). This will ensure that ISPVs continue to meet the relevant RID requirements as set out in Box 2.

Rules applied to the 'ceding' insurer - taking credit for ISPVs

3.21. To enable a ceding firm to benefit from a transaction with an ISPV we have proposed more detailed rules so that upon application, with supporting evidence and our agreement:

- amounts recoverable from ISPVs may be considered as reinsurance or retrocession, in calculating the ceding firm's solvency margin requirement; and
- amounts outstanding from an ISPV may be treated as reducing, or included as assets covering, technical provisions.

3.22. We propose to operate the application and approval process envisaged by the RID by requiring a ceding firm to apply for a waiver setting out the impact that the arrangement will have on their ICA. This will be required in respect of ISPVs authorised in the UK or any other Member State. Once a waiver has been granted the ceding firm will be required to disclose it in the usual way, including through the FSA website and the FSA returns. We would expect the following to be addressed as part of the firm's ICA documentation, in support of the waiver:

- analysis of the extent to which risk transfer takes place, including under stress scenario analyses, taking account of both the economic analysis and the legal robustness of the structure; and
- the potential for risk to revert to the firm or its related companies under foreseeable adverse scenarios, or for unprovided liabilities to arise, in respect of the risks transferred.

Taking credit for an ISPV on the regulatory balance sheet

3.23. Under our proposals, a key test that all ISPVs will need to meet before credit can be taken on the regulatory balance sheet will be compliance with the proposed risk-transfer principle that is set out in Chapter 4.

3.24. When the ceding firm's supervisor is content that the supporting documents provided with the waiver application is adequate, and after we review the effectiveness of the ISPV as a risk mitigator for the ceding firm, we will consider granting the waiver. If the waiver is granted, the ceding firm will be allowed:

- in the case of a non-life insurer or reinsurer, to include the ISPV as a reinsurance asset; or
- in the case of a life insurer or reinsurer, to deduct any liabilities covered by the ISPV from its gross liabilities.

Using ISPVs for monetisation – creating an ISPV asset:

3.25. We propose that a waiver application will also be required where an ISPV is used for a transaction that is not intended to affect a firm's solvency margin requirement or technical provisions, but to create an asset, such as a life embedded value monetisation. The waiver application will enable us to ensure that, in the absence of minimum European standards, UK firms can take credit for an ISPV only where the ISPV meets our requirements. The risk-transfer principle, described in Chapter 4, may have little impact in this area, as reducing the solvency margin is not generally a primary objective of this type of arrangement.

3.26. Where the ceding firm itself has invested in bonds issued by the ISPV, we would expect the amount of the ISPV asset to be reduced, on a pound-for-pound basis, by the amount of finance provided by the ceding firm. In the case of an insurance group where another group entity holds some of the bonds in a monetisation ISPV, we would expect the amount of the ISPV asset reflected in the group regulatory balance sheet to be reduced accordingly. Further details on our proposals for insurance groups and conglomerates are set out in Chapter 5.

> Q8: Do you agree with our proposed approach to the authorisation of ISPVs? Do you have any comments on our proposals for the supervision of ISPVs?

4 Introducing a principles-based approach for risk transfer

Introduction

4.1. Increasingly we have seen significant interest from insurance firms wishing to enter into innovative risk transfer transactions. Such transactions have used securitisations, financial reinsurance, contingent loans and other financial instruments to effect the risk transfer. FSMA makes clear that we should recognise the desirability of both competition and innovation, and that in discharging its powers, we should also seek to minimise competitive distortions caused by over-regulation. In this chapter we propose a high-level, principle-based rule to assess the extent to which there has been a transfer of risk in relation to the benefit taken in the regulatory balance sheet.

Options considered

4.2. In determining our policy approach, we considered two main options:

- define the types of transactions that do not fit well with our current rules and prescribe a new set of detailed rules for those transactions; or
- adopt a principles-based approach for ISPVs, financial reinsurance and other similar transactions.

4.3. Our proposed policy is to take the latter option. It is our view that, in an innovative environment, trying to differentiate types of transactions through prescriptive rules can be inefficient and cause competitive distortions, rendering a rules-based framework ineffective and quickly outdated. Applying a single principles-based policy to ISPVs and financial reinsurance arrangements should increase competition amongst the wholesale providers of risk transfer transactions and minimise the market distortions that regulation creates.

4.4. The proposals discussed in this chapter are in addition to our proposals in CP05/14 (Quarterly Consultation 06, October 2005), which use additional disclosure as a tool for dealing with non-life financial reinsurance contracts. In line with CP05/14 and our principles-based approach, we do not intend to develop a definition of financial reinsurance, although the characteristics set out in Chapter 3 of CP05/14 give some indication. We consider that developing a definition of financial reinsurance would be inefficient and could render our rules ineffective.

Developing a high-level principle for risk transfer

4.5. Our starting point in developing our approach has been to look at our Principles for Business and in particular, our Principle that a firm should have adequate financial resources. For a firm to demonstrate that it has adequate financial resources it must not understate the risks to which it is exposed or overstate its capital position. If a risk transfer transaction results in an understatement of risk or an overstatement of capital, a firm cannot demonstrate compliance with this high-level principle.

Proposed high-level risk-transfer principle

4.6. Transactions must be effective at transferring the risk they purport to transfer. This may be on a full or partial basis and will be determined by the documentation of the specific transaction, which will determine the level of risk transferred. We have set out some guidance on factors that firms should consider when drawing up the contract that brings about the risk transfer, such as commitments to provide additional support to a transaction (see INSPRU 1.1.19F).

4.7. In developing our policy we have also considered the differences between legal entity and group risks. We propose to apply the policy consistently on both a solo legal entity basis and a group basis. We do not intend the introduction of the risk-transfer principle to prevent over-collateralisation of an embedded value transaction.

4.8. In some circumstances a firm may undertake to give support to the counterparty which is not reflected in its overall assessment of the risk transferred. We call this implicit support. A firm providing implicit support might be motivated by a desire to reduce potential losses to its counterparty or prevent damage to its reputation. It is not our intention to restrict a firm's future discretion, but it is not appropriate that a firm should commit to provide implicit support while obtaining benefits in the regulatory balance sheet that do not take the implicit support into consideration.

Applying the risk-transfer principle

4.9. To help firms understand how the risk-transfer principle could be applied in practice, we have included some guidance with the rule describing the risk-transfer principle as set out in Annex 1 of this paper. Broadly, we envisage a two-step process:

Step 1: Assessing the level of effective risk transfer

4.10. To assess the level of risk-transfer arising from a transaction, a firm would need to ensure that the legal documentation associated with the transaction identifies the level of risk actually being transferred and reflects the economic substance of the transaction. This should include ensuring the risks being transferred are incontrovertible and there are no conditions to fulfil that would be outside the firm's control (INSPRU 1.1.19E).

Step 2: Application of the risk-transfer principle to…

… the ICA

4.11. To calculate the amount of credit that can be taken through its ICA calculation a firm should refer to the level of risk that has been effectively transferred as determined in Step 1. We would expect a firm to use its existing ICA methodology to determine the benefit derived on an economic basis.

… the regulatory balance sheet

4.12. A firm should measure the amount of credit it can take for risks that have been effectively transferred by applying the standard methods for determining the regulatory balance sheet set out in INSPRU. For example, where credit is being taken to reduce technical provisions, the amount of that credit should reflect the difference in technical provisions that arises from changing the assumptions used to reflect the risk transferred (INSPRU 1.1.19D).

> Q9: Do you agree with our proposal to introduce a principles-based approach for risk transfer?

Extension of the risk-transfer principle to all other reinsurance contracts

4.13. The principle set out above has been developed in the context of ISPVs and financial reinsurance arrangements. These principles are not too dissimilar to the overall objectives of traditional reinsurance arrangements which are aimed at effective risk transfer to the reinsurer. We are therefore considering whether we should extend the scope of our risk-transfer principle to all reinsurance contracts and are interested in participants' views.

> Q10: Do you agree we should consider applying the risk-transfer principles we are proposing to all reinsurance contracts? How would this widening of scope affect other reinsurance arrangements?

5 Insurance groups and conglomerates

5.1. This chapter sets out our proposals to amend our groups' rules to reflect the introduction of the RID. We propose to:

- apply our insurance groups' rules to groups that consist entirely of reinsurance entities;
- extend our RID proposals set out in earlier chapters to pure reinsurers and mixed insurers[6] that are part of insurance groups; and
- apply principles for financial reinsurance and ISPV transactions, as outlined in Chapter 4, at the group level.

Applying the Insurance Groups Directive (IGD) to groups that consist entirely of reinsurance entities

Background

5.2. The IGD, as amended by the RID, will for the first time apply to groups that consist entirely of reinsurance entities. So, a group that consists entirely of reinsurance entities will be required to prepare the group capital adequacy calculations.

5.3. We propose to implement these amendments to the IGD on 31 December 2006 which will be at the same time as the changes to the solo requirements set out in earlier chapters, but with two exceptions which are explained below.

'Hard' group capital adequacy test and disclosure requirements

5.4. Our IGD rules include a requirement for an insurance group's capital resources to be equal to or exceed the group's capital resources requirements (hard test), and a requirement to disclose publicly a group's capital adequacy position. As we plan to implement the RID on 31 December 2006, a year earlier than the EU deadline, we

6 The RID defines a mixed insurer as a direct insurer that also does reinsurance business where the reinsurance premiums collected exceed 10% of the firm's total premiums, or reinsurance premiums collected exceed 50m, or where technical provisions resulting from the firm's reinsurance acceptances exceed 10% of their total technical provisions.

anticipate that some member states may not have implemented the RID. If a group's members include reinsurers in EEA states which have not implemented the RID on or before 31 December 2006, we propose to treat them as reinsurance undertakings that are located in a designated state or territory for the purpose of the group capital adequacy calculations[7]. With this in mind, we propose to wait until the EU implementation deadline of 10 December 2007 to implement our 'hard test' and disclosure requirements for groups that consist entirely of reinsurance entities.

5.5. If you think your firm will be affected, please answer the following question.

Q11: Is your firm a member of a group which consists entirely of reinsurance entities? If so, do you agree with our proposals for implementation dates?

Reciprocal use of capital

5.6. The IGD disallows reciprocal financing within a group (Annex I, 1D). Reciprocal financing typically exists when an entity holds shares in, or makes loans to, another group entity which, directly or indirectly, holds capital in the first entity. In this situation, the two group entities hold capital in each other and this should be eliminated in the group capital adequacy calculations. We have inserted INSPRU 6.1.42A to make this clearer.

Treatment of reinsurers and ISPVs in the Group Capital Resources Requirement (GCRR) calculations

5.7. The GCRR for insurance groups is calculated by aggregating Capital Resources Requirements (CRR) of individual entities (including regulated entities and financial institutions).

5.8. For the group calculations, we currently calculate a reinsurer's CRR on the basis of the direct insurance rules. We propose to amend this so a reinsurer's CRR will be calculated in line with the RID. So, the CRRs for pure reinsurers and UK mixed insurers will be calculated in line with our proposals set out in Chapter 2.

5.9. As we explained earlier, we propose to treat reinsurers in EEA states which have not implemented the RID on or before 31 December 2006, as reinsurance undertakings that are located in a designated state or territory for the purpose of the GCRR calculations until 10 December 2007, the EU deadline for implementing the RID.

5.10. In Chapter 3, we explained our proposal for authorising UK ISPVs. If a group's members include UK or EEA ISPVs, they would be brought into the GCRR calculation by using their CRRs, calculated in line with the solvency requirements of the regulator who authorised them as ISPVs. We would treat non-EEA ISPVs as non-EEA reinsurance undertakings for the GCRR calculations.

7 Designated states and territories are 'any *EEA State* (other than the *United Kingdom*), Australia, Canada or a province of Canada, Hong Kong, Singapore, South Africa, Switzerland, a State in the United States of America, the District of Columbia or Puerto Rico'. We will provide transitional rules on how we will treat this requirement in our final RID rules which are scheduled to be published by 31 December 2006.

Risk transfer transactions at group level

5.11. We set out our proposals for risk transfer transactions at the solo entity level in detail in Chapter 4 of this CP. Generally, the group rules allow benefits realised from such transactions at the solo entity level to be carried over to the group calculations. There are two areas where we propose to make some adjustments at the group level to allow the changes at the solo entity level to flow through to the adjusted solo and group solvency calculations:

- Intra-group reinsurance: as set out in Chapter 2, the RID sets the CRR for life pure reinsurers' and mixed insurers' long-term reinsurance protection business at the minimum RID level for non-life reinsurance. As part of our RID implementation, these requirements will be reflected in the GCRR calculation; this means a group's Pillar 1 capital requirements may fall as a result of intra-group reinsurance. Where relevant, we will continue to review the ICAS assessments of groups on a consolidated basis, so as to assess the underlying risk profile, without distortion by intra-group reinsurance transactions that do not alter the risk profile of the group as a whole. If appropriate, we will base our Pillar 2 ICG on this assessment, which may therefore diverge from the Pillar 1 treatment.
- Intra-group risk transfer through ISPVs: if any risk is transferred, using an ISPV, from one entity (A) to the other (B) in the same group that is subject to either the adjusted solo or insurance group calculation, we propose to allow entity A to benefit from such a transaction at the solo entity level. This is provided the transaction is in line with the principle set out in Chapter 4. Where risks have not been transferred out of the group, we believe this should be reflected in the group capital adequacy calculations. In Chapter 3, we explained that we would require a ceding firm wishing to use an ISPV to apply for a waiver. We propose that a ceding firm would also be expected to set out the impact that the ISPV arrangement would have on their group capital adequacy calculations in their waiver application.

Impact of the RID implementation for the Financial Conglomerates Directive (FCD)

5.12. This section only applies to financial conglomerates whose most important financial sector is the reinsuranc sector (insurance-led conglomerates).

5.13. The FCD refers to the IGD group calculation method when the conglomerate capital adequacy calculation for insurance-led conglomerates is performed. Consequently, the RID amendments to the IGD, as explained in this chapter, would be reflected in the FCD in a consistent manner. So if an insurance conglomerate's members include reinsurers, the RID requirements would be used for calculating their CRRs.

> Q12: Do you agree with our proposals to implement the RID for insurance groups and conglomerates?

6 Changes to the insurance annual returns

6.1. To support the changes we are proposing to the prudential regime for reinsurers and mixed insurers, including the introduction of the ISPV regime, we would need to make some adjustments to our insurance annual returns in the Interim Prudential Sourcebook for Insurers (IPRU(INS)). We are consulting on the basis of the current IPRU(INS) text, which is not updated to reflect the development of GENPRU and INSPRU, and therefore cross-references to prudential rules in Appendix 1 are to PRU.

6.2. In Chapter 2, we proposed moving the solvency margin for life reinsurance protection and PHI business, for pure reinsurers and mixed insurers, onto the non-life basis. We propose to require these firms to complete forms 11 and 12 (calculation of the general insurance capital requirement) and reflect the result in form 60. To ensure the non-life solvency margin calculation gives a realistic result where a discount is provided on initial premiums, we propose to require firms to ignore discounts during any initial period when calculating the premium amount.

6.3. In Chapter 3, we proposed that amounts recoverable from ISPVs will be eligible to count towards the ceding firm's technical provisions and solvency margin. We propose that, in our Insurance Prudential Sourcebook (INSPRU), such amounts be classified as a subset of the total amount reinsured, meaning that they will appear on the returns as reinsurance (form 13.60-62 for non-life business and form 51 for life business). We propose to amend the notes to form 13 to require firms to indicate what proportion of non-life reinsurance was provided by ISPVs. We consider that an additional note to form 51 is not required as we require full disclosure of reinsurance in Appendix 9.4 paragraph 9.

6.4. The proposals discussed in this chapter are separate from our proposals in CP05/14 (Quarterly Consultation 06, October 2005), which set out additional disclosure requirements for non-life financial reinsurance contracts.

6.5. Under the RID, pure reinsurers' assets and investment strategy will be governed by the five prudent person investment principles. Reinsurers will continue to provide a breakdown of their assets by class through form 13, although all pure reinsurers' assets will now be admissible where the prudent person principles are met.

Q13: Do you agree with our proposed changes to the insurance annual returns?

7 Market failure and cost benefit analysis

Introduction

7.1. FSMA requires us to publish a cost-benefit analysis when we publish draft rules or guidance on rules. This includes an analysis of the benefits and an estimate of the costs that will arise from the proposals being made. In this chapter we have estimated and analysed the incremental costs and benefits of our proposals, taking as the baseline what firms would do if the proposals were not implemented.

7.2. The economic market identified as being affected by the changes proposed in this paper is the reinsurance market. There are 14 pure reinsurers in the UK, eight of these provide life reinsurance and generally focus on protection (mortality and morbidity) business. There are also 50 mixed life firms in the UK, many of these firms are affected because of intra-group reinsurance and often write significant amounts of unit linked and with profits business. We understand that the existing population of mixed firms write a very small amount of reinsurance protection business.

7.3. While the changes proposed in this paper arise through the implementation of the RID and not because of any identified market failure, our approach to implementation attempts to address regulatory imperfections in the form of inappropriate or excessive prior regulation. Such cases identified in this paper are:

i) Pillar 1 capital requirement for pure life reinsurance firms in excess of the RID and ICAS requirements;

ii) different capital requirements for pure and mixed life reinsurers for the same protection business;

iii) unnecessarily high requirements for the calculation of technical provisions;

iv) failure to recognise lower capital requirements and technical provisions at the group level; and

v) potentially onerous regulation of ISPVs as reinsurers, even though they are fully funded through the capital market.

7.4. Solvency requirements and technical provisions for reinsurance firms are material to our market confidence and consumer protection objectives. The likely market failures they are meant to address are negative externalities and information asymmetry problems leading to cases where firms may not be holding sufficient capital. In such cases there may be inadequate resources held to prevent failure. As a result, insurers and consequently consumers of insurance could incur costs directly in the form of losses stemming from the failure of reinsurance firms and indirectly in the form of opportunity costs associated with time spent dealing with the process of collecting due compensation.

7.5. Since December 2004 UK, reinsurance firms have been within the new domestic ICAS regime, so there are now alternative, more firm specific, measures in place to deal with relevant risks to objectives. We think firms may have been over reserved for life protection business. Similarly, ISPVs may have been over regulated as reinsurers even though they are fully funded through the capital market. Our proposed approach to implementing the RID attempts to remove such possible areas of excessive regulation.

Cost-benefit analysis (CBA)

7.6. As described in Chapter 1, the general approach of the RID is to apply the Non-Life Directives to life and non-life reinsurance business. We believe there will be no significant impact on our existing rules for non-life reinsurance business, which are already based on the Non-Life Directives. With this in mind, this CBA focuses on the movement from our current rules for life reinsurers, which are based on the Life Assurance Directive, to rules based on the Non-Life Directives, and other changes introduced by the RID that depart from the insurance Directives and consequentially our existing rules. We intend to introduce a minimum implementation of the RID and, where the RID gives us discretion, to avoid unnecessary additions.

7.7. Cost benefit implications for the treatment of each proposal at group level (Chapter 5) are examined alongside the analysis for each proposal at firm level where relevant. The proposed consequential changes to the insurance return (Chapter 6) will create costs of no more than minimal significance and are not discussed below. One-off systems development costs to calculate new requirements are considered alongside each proposal. However, we would be happy to receive any comments regarding the potential cost of our proposed changes to the annual return.

Reducing the solvency margin and level of technical provisions for long-term reinsurance protection business for pure reinsurers (Chapter 2)

7.8. As set out in Chapter 2, we propose to move pure life reinsurers' Pillar 1 capital requirements for long-term insurance protection business onto the RID minimum (non-life basis), and remove certain specific rules that determine technical provisions for pure reinsurers' long-term insurance protection business. In Chapter 5 we also set out our proposal to recognise these changes within our rules for groups.

Potential benefits

- Where pure reinsurers' Pillar 1 capital requirements are significantly above the ICAS requirement, the firm will be able to free up regulatory capital. Based on information provided through discussions with firms, we expect the aggregate in excess capital from the combination of an average 50% reduction in the solvency requirement and 30% reduction in technical provisions for life protection (mortality) business and PHI, to amount to approximately £730m for the total population of pure reinsurers. As explained in Chapter 2, Pillar 1 capital that firms may release because of the reduced solvency requirement for life protection (mortality) and PHI business is estimated to be around £280m. And the capital that may be released from the reduced level of technical provisions for mortality and PHI business is estimated to be approximately £710m. We expect the amount of capital freed up for some firms will be limited by their ICA requirement, because of which we estimate the aggregate possible release of capital to be around £730m. Applying a marginal cost of capital of 3.5% per annum, the overall decrease in regulatory capital requirements of £730m could lead to cost savings, for the UK's eight pure reinsurers, of approximately £25m a year[8].
- Reinsurers could pass on some of their cost of capital savings to reinsurance buyers and, hence, insurance buyers in terms of lower prices for reinsurance products. In practice, this will depend on the degree of competition in reinsurance and insurance markets.
- The RID allows a reduction in the calculation of the GCRR arising from intra-group reinsurance. Previously, the GCRR calculation did not allow this reduction. The decrease in life reinsurance solvency requirements and technical provisions discussed is also recognised at the group level in our proposals. As a result, intra-group reinsurance transactions could become more attractive, potentially leading to cost savings, which could be passed through to consumers in the form of price reductions (depending on the level of competition in the market).
- We do not assume that regulatory capital changes feed directly through to one-for-one changes in actual capital. Our estimated figure of cost of capital savings provides an upper limit estimate of the impact of regulatory capital decrease. Previous examinations of financial service firms suggest that while firms adjust actual capital in response to changes in regulatory requirements, they do not adjust actual capital levels by the full amount of changes in regulatory requirements. FSA Occasional

8 Our estimated cost of capital for life insurance firms is the difference between the cost of equity capital for those firms and the return that they could make on that capital if it was invested in risk-free assets. Different firms may have different costs of capital, and because of uncertainty about future returns, there is no single 'right' estimate of the cost of capital. Our estimate is as applied in the CBA of CP190 and 195.

Paper 22 groups the reasons for this under two categories: internal factors (e.g. to maintain a cushion against an economic downturn), and market discipline factors (e.g. to maintain an external credit rating).

Costs

- Pure reinsurers, and groups whose members include pure reinsurers, will have to change the way in which they calculate and report their solvency requirements, which will involve small one-off systems development, testing and training costs. These costs vary depending on the size of the firm involved, but from information firms have given us, we believe this could amount to one-off costs of approximately £0.4m across the industry. Additional ongoing costs are not expected. Notably, firms have clearly indicated that capital benefits arising from these proposals exceed compliance costs.
- For firms and groups that are able to take advantage of the reduced Pillar 1 requirements, the reduction in Pillar 1 capital and the lower level of technical provisions may increase uncertainty (of whether claims will be paid) in the insurance market. The effect of the reduction in capital will be constrained by ICAS at a level that amounts to a 99.5% confidence level over one year, and by our requirement for firms to hold technical provisions with an adequate risk margin[9]. We consider that in some cases current levels of Pillar 1 capital may have been consistent with a confidence level of up to 99.9% over one year. An examination of the market suggests that firms will generally hold capital above the regulatory minimum, indicating that the actual confidence level consistent with the capital they hold is likely to be above the 99.5% over one year determined by ICAS.

Reducing the capital requirement for the life protection (mortality) business of mixed insurers (Chapter 2)

7.9. Currently our Pillar 1 capital requirement for pure reinsurers' life protection (mortality) business is lower than the equivalent requirement for direct insurers' reinsurance business[10]. In Chapter 2 we propose removing this discrepancy.

Potential benefits

- There are currently around 50 mixed life insurers in the UK. As a result of our proposals, mixed insurers would be able to take on reinsurance business if it is economically efficient for them to do so, without incurring a higher capital requirement than pure reinsurers. The reduced capital requirements for mixed insurers' life protection reinsurance business will not prevent these firms from

9 We consider the current rules for calculating technical provisions to be overly prudent for life reinsurance protection business.

10 In the UK the solvency margin calculation for pure reinsurers writing classes I, II and IX differs as follows:
- for the first calculation based on a firm's mathematical reserves pure reinsurers are allowed a larger reinsurance reduction factor of 50% rather than 15%; and
- for the second calculation pure reinsurers are only required to hold 0.1% of their capital at risk, irrespective of the length of their insured liabilities.

continuing their current reinsurance programmes. As only a very small amount of reinsurance protection business is done by such firms, the incremental capital savings for the entire population of such firms are expected to be of minimal significance.

- We do not expect the reduced capital requirement for mixed insurers' life protection reinsurance business to affect materially the overall capital held in the system, as under the existing regulatory framework insurers already access lower capital requirements through pure reinsurers or overseas reinsurers. Although we might expect to see the proportion of business going to mixed insurers increasing, the difference between pure reinsurers and mixed insurers in the rules on calculating technical provisions may still make it more cost effective to channel business to pure reinsurers.

Costs

- Mixed insurers that choose to write long-term protection reinsurance business will have to change the way in which they calculate and report their solvency requirements, which will involve small one-off systems development, testing and training costs. As mixed insurers do not generally carry out this type of business, they will choose to do so only where that is efficient. Firms with a small amount of business will not be classified as mixed insurers and will remain on the existing life requirements.
- Where a firm's current Pillar 1 capital requirement is in excess of the Pillar 2 requirement, the reduction in Pillar 1 capital will increase uncertainty (of whether claims will be paid) in the insurance market. However, we do not expect this to be significant as the reduction in capital will be constrained by the firm's Pillar 2 results. This will ensure that firms maintain sufficient capital to a level at least as strong as a 99.5% confidence level over one year, in line with the minimum standard we seek for all direct writers.

Introducing prudent person principles for asset admissibility and allowing pure reinsurers to carry out related operations (Chapter 2)

7.10. As set out in Chapter 2, the RID requires us to introduce prudent person principles in place of our current detailed admissible asset rules. As part of our minimum implementation of the RID, we will be relaxing the restrictions on the business activities of pure reinsurers.

Potential benefits

- We expect the introduction of the prudent person principles to allow pure reinsurers greater investment flexibility, particularly when investing in new or innovative instruments.
- The relaxation of the limitations on the business activities of a pure reinsurer will enable these firms to provide additional services to clients directly without using a service subsidiary, potentially allowing it to reduce operating costs.
- Investigating optimal investment portfolio choices in relation to the regulation of life assurance companies and pension funds, Davis (2001)[11] finds that prudent person principles are superior to quantitative restrictions for pension funds[12]. And he finds that although, in general, restrictions may be less damaging for life insurance, prudent person principles are nevertheless desirable – particularly in competitive markets in advanced economies. Given similarities between life insurance and reinsurance business, these findings may hold some validity for the latter market as well.

Costs

- It is possible that in some cases existing admissible assets might not meet the prudent investment principles. However, this is unlikely as the principles embody many of the existing tests carried out by firms as part of ICAS.
- As similar evaluations form part of a firm's investment management strategy and the existing ICAS review, we do not expect the additional cost of assessing compliance with the principles to be significant.
- The flexibility allowed by prudent person principles could lead to a higher risk of failure than under current quantitative restrictions. However, we are not aware of any quantitative evidence to support this in the economic literature.

Extending the results of the Commission's review of the Base Capital Resource Requirement (BCRR) to pure reinsurers (Chapter 2)

7.11. In Chapter 2 we proposed increasing pure reinsurers' BCRR to reflect the outcome of the Commission's annual inflation review of the amounts prescribed in the Life Assurance and Non-Life Directives. The provision for carrying out an annual inflation review has been carried across to the RID, but the RID was not in force when the 2005 review was carried out and, as a result, the amounts of the BCRR for pure reinsurers and the relevant premiums and claims indices as set out in the RID were not adjusted. This introduced minor inconsistencies in these measures between direct writers and reinsurers. For consistency and clarity we have proposed increasing the amounts set out in the RID in line with the results of the Commission's review.

11 The Pensions Institute, E. Philip Davis, January 2001, Discussion Paper PI-0101.

12 Except in specific circumstances which may arise notably in emerging market economies.

7.12. As we intend to increase the RID BCRR in line with the Commission's review, pure reinsurers will be required to hold a BCRR of €3.2m (€0.2m greater than the amount set out in the RID). We plan to revise the BCRR in step with the Commission's annual review of the BCRR.

7.13. In general, we do not expect the Pillar 1 solvency requirement of UK reinsurers to be determined by the BCRR. We expect therefore in practice firms will not be holding any additional capital from this requirement. So incremental costs and benefits are not expected to arise.

Insurance Special Purpose Vehicles (Chapter 3)

7.14. As explained in Chapter 3, we propose to introduce a fit-for-purpose authorisation and supervision regime. This section of the CBA concentrates on the effects of proposed changes to the authorisation and supervision regime for ISPVs.

7.15. We are not currently aware of many UK firms using ISPV type transactions although some UK firms have set up arrangements with similar characteristics in other Member States and in third countries. Depending on other fiscal factors within Member States and the interest in insurance securitisations within the industry, we might expect to see an increase in the use of ISPVs and other similar vehicles by UK insurers and reinsurers over the next five to ten years.

Potential Benefits

- Our proposals may make the UK a more attractive location for ISPVs and facilitate the development of a market in the UK. Setting up ISPVs in the UK could reduce costs for firms which currently enter into these arrangements elsewhere by eliminating the duplicate compliance burdens.
- Other financial services firms will no longer need to go through or establish an authorised reinsurer to transfer the risks outside of the firm, increasing competition in the industry and reducing the cost of finance for insurers. This should in turn reduce the price of insurance for consumers where insurers access the capital markets through ISPVs.

Costs

- Firms will choose to set up ISPVs, and incur any resultant costs, where they determine it is economically efficient for them to do so. This will include costs of developing an understanding of what is required to meet the FSA's authorisation and regulatory requirements where they are different to the existing regime.
- There will be additional direct costs to the FSA for developing the new authorisation process and in training authorisation staff on the new approach; we have estimated these costs at approximately £25,000. Supervisors will also need to have general awareness of the approach. However, these costs are not

expected to be significant as only a small number of staff will need to develop the expertise for these arrangements.

Introducing principles for risks transfer under financial reinsurance arrangements (Chapter 4)

7.16. In Chapter 4 we proposed to introduce a high-level, principles-based approach for innovative risk transfer transactions using financial reinsurance or ISPVs. The principle we are proposing is intended to clearly articulate the basis on which we are already supervising and allowing regulatory credit for these arrangements.

Impact

- We already require firms to meet the principle set out in Chapter 4, though now this is made explicit as a rule. The proposed principle may help firms clearly understand how we expect them to approach risk transfer transactions, reducing the level of FSA involvement required and allowing transactions to be developed more efficiently with less iteration. As we will not be removing any of our existing rules we do not expect greater risk implications for consumers.
- Preliminary conversations with firms have indicated that the cost of complying with the proposed risk-transfer principle should not be significant, given that ceding firms will already be considering which risks have been transferred under the contract.
- Our proposed rules would allow firms to benefit from risk transfer transactions using ISPVs at the solo level, but not at the group level if risks have not been transferred out of the group. Our existing rules for groups already have this effect so we do not expect significant additional costs to arise.

Introducing the 'hard' test for groups that consist entirely of reinsurers (Chapter 5)

7.17. In Chapter 5 we set out our proposal to introduce a 'hard' group capital adequacy test and a public disclosure requirement for groups that consist entirely of reinsurance entities.

7.18. We conducted a detailed CBA of the same requirement in CP204 when we proposed to implement it for insurance groups. There were 90 insurance groups identified at that stage, and the analysis indicated that some groups needed to raise capital to meet the hard test requirement with consequent capital costs.

7.19. Our understanding is that, in contrast, there are very few reinsurance groups and that they already meet the "hard" test requirement. Consequently, we expect no further compliance costs (and no incremental benefits arising from any change in behaviour). While we have not identified any reinsurance group which does not already meet the hard requirement, if such cases exist we would expect additional capital costs which would depend on the level of capital deficit.

8 Compatibility with our objectives and principles of good regulation

8.1. This chapter sets out our views on how our proposals for implementing the RID in the UK are compatible with our objectives and principles of good regulation.

Compatibility with our statutory objectives

Market confidence and consumer protection

8.2. These objectives require us to maintain confidence in the UK financial system and to ensure adequate levels of consumer protection. Where our draft rules and guidance reduce the Pillar 1 solvency margin and technical provisions currently held by firms, the ICAS risk-based solvency requirements will ensure that firms maintain sufficient capital to a level at least as strong as a 99.5% confidence level over one year. This will ensure the risk of market disruption arising from financial failure in an authorised firm, or group of firms, is maintained at an acceptable level, and an adequate level of consumer protection is preserved.

8.3. The fit-for purpose regime we are proposing for fully funded ISPVs – while recognising that a less detailed prudential regime is appropriate – will nonetheless require firms ceding risks to ISPVs to monitor the residual risks associated with the ISPV. They should maintain capital at a level that is at least as strong as a 99.5% level of confidence over one year at all times.

Public awareness and the reduction of financial crime

8.4. Our proposals are not directly aimed at promoting public awareness or reducing financial crime. Where a waiver is granted to an insurer or reinsurer to count an ISPV towards its capital requirements, the usual disclosures will be made, including a notification on our website and through the FSA returns. Where necessary we propose changes to the annual insurance return to reflect our proposed changes, and this information will be publicly available.

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

8.5. Under section 2 (3) of the Financial Services and Markets Act 2000 (FSMA), we must consider the specific matters set out below when carrying out our general functions.

Need to use our resources in the most efficient and economic way

8.6. We have carried out an extensive pre-consultation exercise with the industry and made three pre-consultation papers publicly available on our Insurance Standing Group website (www.fsa.gov.uk/Pages/About/What/International/solvency/isg/index.shtml).

8.7. Our intention was to give the industry as much opportunity as possible to comment on our proposals in advance of this consultation. This will help us implement the final rules by the December 2006 year-end, allowing firms the maximum possible benefit from our proposals for year-end reporting purposes.

8.8. Our approach to implementation contains several important elements designed to ensure that we use our resources efficiently. These include:

- using a minimum implementation approach wherever appropriate, which means only making changes to our existing rules where they are required;
- introducing fit-for-purpose authorisation and supervision of ISPVs based on the existing regime for insurers, reducing the costs associated with developing and establishing systems for an entirely new regime; and
- where we have introduced new rules, relying on principles wherever possible (e.g. financial reinsurance).

Responsibilities of those who manage the affairs of authorised persons

8.9. We are proposing a minimum implementation wherever possible. This means that prescription and guidance is reduced, allowing firms to accept more responsibility for compliance matters.

Facilitating innovation in connection with regulated activities

8.10. In Chapter 3 we proposed the introduction of a fit-for-purpose regime for ISPVs, recognising that these entities do not need to be subject to the full burden of authorisation and regulation. We aim to remove regulatory barriers to UK innovation and product development in this area.

International character of financial services and markets and the desirability of maintaining the competitive position of the UK

8.11. Our intention is to introduce a minimum implementation of the RID in the UK, placing reliance on our ICAS regime to ensure that capital at least as strong as a 99.5% confidence level over one year is maintained. For example, we propose a lower solvency margin and fewer restrictions on technical provisions for some life reinsurance business and suggest relaxing restrictions on reinsurers' activities.

8.12. We believe this will enhance the competitiveness of the UK reinsurance industry. In addition, we have set out our proposal to introduce a fit-for-purpose regime for ISPVs, which we believe removes the regulatory barriers to the development of an ISPV market in the UK.

Facilitating competition between those who are subject to our regulation

8.13. Wherever possible, we have attempted to make more consistent the requirements between pure reinsurers and direct insurers, for example by changing our rules so that mixed insurers are no longer subject to a higher solvency margin than pure reinsurers. Our aim is that introducing a risk-based fit-for-purpose authorisation process for ISPVs will make it more viable for financial institutions to facilitate insurance securitisations where this is appropriate.

Most appropriate way for us to meet our regulatory objectives

8.14. We must set out why we think our standards are the most appropriate way to meet our obligations. The RID is an EU Directive that we must implement in the UK. The proposals in this CP are intended to introduce a minimum implementation of the Directive, ensuring the UK remains competitive with other Member States. An adequate level of consumer protection will be maintained through our ICAS regime, which will continue to require firms to hold capital at a level that amounts to a 99.5% level of confidence over one year.

List of questions in this Consultation Paper

Chapter 2 – Proposals affecting life and non-life reinsurance business

Q1: Do you agree with our minimal approach to implementing the prudent person, principles-based rules for reinsurance business?

Q2: Do you agree with our proposal not to implement the prudent person principles and associated ring fencing requirements for mixed insurers' reinsurance business?

Q3: Do you agree with the proposal to use the non-life solvency margin for the long-term life protection business of pure reinsurers and mixed insurers?

Q4: Do you agree that we should not extend the non-life solvency rules to investment and annuity business?

Q5: Do you agree that in setting the technical provisions for pure reinsurers' protection and PHI business, we should use a best estimate plus risk margin approach?

Q6: Do you agree that we should relax our existing restrictions on reinsurers' activities to include related operations in addition to conducting reinsurance?

Q7: Do you agree that we should align the BCRR for pure reinsurers with that for direct insurers?

Chapter 3 – Insurance Special Purpose Vehicles

Q8: Do you agree with our proposed approach to the authorisation of ISPVs? Do you have any comments on our proposals for the supervision of ISPVs?

Chapter 4 – Introducing a principles-based approach for risk transfer

Q9: Do you agree with our proposal to introduce a principles-based approach for risk transfer?

Q10: Do you agree we should consider applying the insurance risk-transfer principles we are proposing to all reinsurance contracts? How would this widening of scope affect other reinsurance arrangements?

Chapter 5 – Insurance groups and conglomerates

Q11: Is your firm a member of a group which consists entirely of reinsurance entities? If so, do you agree with our proposals for implementation dates?

Q12: Do you agree with our proposals to implement the RID for insurance groups and conglomerates?

Chapter 6 – Changes to the insurance annual returns

Q13: Do you agree with our proposed changes to the insurance annual returns?

Draft Handbook Text

REINSURANCE DIRECTIVE INSTRUMENT 2006

Powers exercised

A. The Financial Services Authority makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 ("the Act"):

(1) section 138 (General rule-making power);
(2) section 141 (Insurance business rules);
(3) section 150(2) (Actions for damages);
(4) section 156 (General supplementary powers);
(5) section 157(1) (Guidance); and
(6) section 340 (Appointment).

B. The rule-making powers listed above are specified for the purpose of section 153(2) (Rule-making instruments) of the Act.

Commencement

C. This instrument comes into force on 31 December 2006.

Amendments to the Insurance Prudential sourcebook

D. The Insurance Prudential sourcebook (INSPRU) is amended:

(1) by inserting INSPRU 1.6 as set out in Annex D to this instrument; and

(2) in accordance with Annex E to this instrument.

Other amendments to the Handbook

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

(1)	(2)
Glossary of definitions	Annex A
Senior Management Arrangements, Systems and Controls (SYSC)	Annex B
General Prudential sourcebook (GENPRU)	Annex C
Interim Prudential sourcebook for Insurers (IPRU-INS)	Annex F
Supervision manual (SUP)	Annex G

Citation

G. This instrument may be cited as the Reinsurance Directive Instrument 2006.

By order of the Board
[ ] 2006

Annex A

Amendments to the Glossary of definitions

In this Annex underlining indicates new text and striking through indicates deleted text. Where new definitions are being inserted, the text is not underlined.

Part 1: New definitions

Insert the following new definitions in the appropriate alphabetical position:

captive reinsurer	a *pure reinsurer* owned by: (a) a financial *undertaking* other than an *insurance undertaking* or a *reinsurance undertaking*; or (b) a *group* of *insurance undertakings* or *reinsurance undertakings* to which the *Insurance Groups Directive* applies; or (c) a non-financial *undertaking*, the purpose of which is to provide *reinsurance* cover exclusively for the risks of the *undertaking* or *undertakings* to which it belongs or of an *undertaking* or *undertakings* of the *group* of which that *pure reinsurer* is a member.
EEA ISPV	an *ISPV* (including a *UK ISPV*) whose head office is in any *EEA State* and which has received authorisation pursuant to article 46 of the *Reinsurance Directive* from its *Home State Regulator*.
EEA pure reinsurer	a *reinsurance undertaking* (other than an *ISPV*) whose head office is in any *EEA State* except the *United Kingdom* and which has received authorisation under article 3 of the *Reinsurance Directive* from its *Home State Regulator*.
insurance special purpose vehicle	an *undertaking*, other than an *insurance undertaking* or *reinsurance undertaking* which has received an official authorisation in accordance with article 6 of the *First Non-Life Directive*, article 4 of the *Consolidated Life Directive* or article 3 of the *Reinsurance Directive*: (a) which assumes risks from such *insurance undertakings* or *reinsurance undertakings*; and (b) which fully funds its exposures to such risks through the proceeds of a debt issuance or some other financing mechanism where the repayment rights of the providers of

such debt or other financing mechanism are subordinated to the *undertaking's reinsurance* obligations.

ISPV	an *insurance special purpose vehicle*.
life protection reinsurance business	*reinsurance* acceptances in respect of *contracts of insurance* falling within *long-term insurance business class* I that are not annuities or *with-profits insurance contracts*.
mixed insurer	an *insurer* (other than a *pure reinsurer*) which carries on *reinsurance* business and where one or more of the following conditions is met in respect of its *reinsurance* acceptances: (a) the *premiums* collected in respect of those acceptances during the previous *financial year* exceeded 10% of its total *premiums* collected during that year; (b) the *premiums* collected in respect of those acceptances during the previous *financial year* exceeded €50 million; and (c) the *technical provisions* in respect of those acceptances at the end of the previous *financial year* exceeded 10% of its total *technical provisions* at the end of that year.
permanent health reinsurance business	*reinsurance* acceptances in respect of *contracts of insurance* falling within *long-term insurance business class* IV.
Reinsurance Directive	the Directive of 16 November 2005 of the European Parliament and of the Council (No 2005/68/EC) on reinsurance and amending the *First Non-Life Directive* and the *Third Non-Life Directive* as well as the *Insurance Groups Directive* and the *Consolidated Life Directive*.
reinsurance undertaking	an *insurance undertaking* whose *insurance business* is restricted to *reinsurance*.
UK ISPV	an *ISPV* with a *Part IV permission* to *effect* or *carry out contracts of insurance*.

Part 2: Amended definitions

Amend the following definitions as shown:

admissible asset	(1)… (2) otherwise<ins>:</ins> <ins>(a) (in relation to an *insurer* which is not a *pure reinsurer*)</ins>

an asset that falls into one or more categories in *GENPRU* 2 Ann 1R; or

(b) (in relation to a *pure reinsurer*) an asset invested in accordance with the requirements in *INSPRU* 3.1.61AR.

EEA firm

…

(f) … ~~.~~;

(g) an *undertaking* pursuing the activity of reinsurance (within the meaning of article 1 of the *Reinsurance Directive*) which has received authorisation under article 3 of the *Reinsurance Directive* from its *Home State Regulator*.

insurance health risk and life protection reinsurance capital component

one of the components of the *long-term insurance capital requirement* as set out in *INSPRU* 1.1.85R to *INSPRU* 1.1.86R.

insurance holding company

(1) a *parent undertaking*, other than an *insurance undertaking*, the main business of which is to acquire and hold participations in *subsidiary undertakings* and which fulfils the following conditions:

(a) its *subsidiary undertakings* are either exclusively or mainly *insurance undertakings*; and

(b) at least one of those *subsidiary undertakings* is an ~~*UK*~~ *insurer* or an *EEA firm* that is a *regulated insurance entity* or a *reinsurance undertaking*;~~ and~~

~~(c) it is not a *mixed financial holding company*.~~

a *parent undertaking*, other than an *insurance undertaking*, that fulfils the conditions in paragraphs 1 (a) and (b) of this definition is not an *insurance holding company* if:

(c) it is a *mixed financial holding company*; and

(d) notice has been given in accordance with Article 4(2) of the *Financial Groups Directive* that the *financial conglomerate* of which it is a *mixed financial holding company* is a *financial conglomerate*.

(2) …

insurer

a *firm* with *permission* to ~~effect~~*effect* or *carry out contracts of insurance* (other than ~~a *bank*~~a *UK ISPV*).

regulated related undertaking

a *related undertaking* that is any of the following:

….

(f) an *insurance holding company*~~.~~; or

(g) an *EEA ISPV*.

Annex B

Amendments to Senior Management Arrangements, Systems and Controls

In this Annex underlining indicates new text and striking through indicates deleted text.

…

3A.1.1	G	…
<u>3A.1.1A</u>	<u>G</u>	<u>*SYSC* 3A applies to a *UK ISPV*.</u>

…

Annex C

Amendments to the General Prudential sourcebook

In this Annex underlining indicates new text and striking through indicates deleted text.

…

1.3.1 R (1) …

(2) …

(3) *GENPRU* 1.3 applies to a *UK ISPV*.

…

1.3.53 G …

Insurance Special Purpose Vehicles

1.3.53A R Except where a *rule* in *GENPRU* or *INSPRU* makes different provision, an *insurer* must not place any value on amounts recoverable from an *ISPV* for the purposes of any *rule* in *GENPRU* or *INSPRU*.

1.3.53B G An *insurer* may value amounts recoverable from an *ISPV* if it obtains a *waiver* of *GENPRU* 1.3.53AR under section 148 of the *Act*. The conditions that will need to be met, in addition to the statutory tests under section 148(4) of the *Act*, before the *FSA* will consider granting such a *waiver* are set out in *INSPRU* 1.6.13G to *INSPRU* 1.6.18G.

…

2.1.2 G The scope of application of *GENPRU* 2.1 is not restricted to *firms* that are subject to the relevant EC Directives. ~~It applies, for example, to *pure reinsurers*.~~

…

2.1.3 R (1) …

(2) Where an *insurer* carries on both *long-term insurance business* and *general insurance business*, except where a particular provision provides otherwise, *GENPRU* 2.1 applies separately to each type of business.

…

2.1.11 R An *insurer* must comply with *GENPRU* 2.1.9R separately in respect of both its *long-term insurance business* and its *general insurance business* unless it is a *pure reinsurer* or a *captive reinsurer* which has a single *MCR* in respect of its entire business in accordance with *GENPRU* 2.1.25AR.

…

2.1.17 R The *CRR* for any *insurer* carrying on *general insurance business* is equal to the *MCR* in *GENPRU* 2.1.24R or, for a *pure reinsurer* or a *captive reinsurer* carrying on both *general insurance business* and *long-term insurance business*, in *GENPRU* 2.1.25AR.

…

2.1.23 R The *CRR* for an *insurer* carrying on *long-term insurance business*, but to which *GENPRU* 2.1.18R does not apply, is equal to the *MCR* in *GENPRU* 2.1.25R or, for a *pure reinsurer* or a *captive reinsurer* carrying on both *general insurance business* and *long-term insurance business*, in *GENPRU* 2.1.25AR.

Calculation of the MCR

2.1.24 R Subject to *GENPRU* 2.1.25AR, f~~F~~or an *insurer* carrying on *general insurance business*, the *MCR* in respect of that business is the higher of:

…

2.1.25 R Subject to *GENPRU* 2.1.25AR, f~~F~~or an *insurer* carrying on *long-term insurance business*, the *MCR* in respect of that business is the higher of:

…

2.1.25A R For a *pure reinsurer* or a *captive reinsurer* carrying on both *general insurance business* and *long-term insurance business*:

(1) the *MCR* in respect of its *general insurance business* is the *general insurance capital requirement*; and

(2) the *MCR* in respect of its *long-term insurance business* is the *long-term insurance capital requirement*;

unless the sum of

(a) the *general insurance capital requirement*; and

(b) the *long-term insurance capital requirement*;

is lower than the *base capital resources requirement*, in which case the *firm* has a single *MCR* in respect of its entire business equal to the *base capital resources requirement*.

2.1.26 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.* For *pure reinsurers* and *captive reinsurers* carrying on both *general insurance business* and *long-term insurance business*, however, the *base capital resources requirement* is the EC Directive required minimum only when it is higher than the sum of the *general insurance capital requirement* and the *long-term insurance capital requirement.* *The base capital resources requirement* is the minimum guarantee fund for the purposes of article 29(2) of the *Consolidated Life Directive* (2002/83/EC), ~~and~~ article 17(2) of the *First Non-Life Directive* (1973/239/EEC) as amended and article 40(2) of the *Reinsurance Directive* (2005/68/EC). The *resilience capital requirement* is an *FSA* requirement that is additional to the EC minimum requirement for *long-term insurance business.*

…

2.1.29 R Table: Base capital resources requirement
This table belongs to *GENPRU* 2.1.28R

…

General insurance business		
Liability *insurer* (*classes* 10-15)	Directive *mutual*	~~€2.25~~ 2.4 million
	Non-directive insurer	€300,000
	Other (including *mixed insurer* but excluding *pure reinsurer* and *captive reinsurer*)	~~€3~~ 3.2 million

Other *insurer*	Directive *mutual*	€~~1.5~~ 1.65 million
	Non-directive insurer (*classes* 1 to 8, 16 or 18)	€225,000
	Non-directive insurer (*classes* 9 or 17)	€150,000
	Mixed insurer	€3.2 million
	Other (excluding *pure reinsurer* and *captive reinsurer*)	€~~2~~ 2.2 million
Long-term insurance business		
Mutual	Directive	€~~2.25~~ 2.4 million
	Non-directive	€600,000
Any other *insurer* (including *mixed insurer* but excluding *pure reinsurer* and *captive reinsurer*)		€~~3~~ 3.2 million
All business (*general insurance business* and *long-term insurance business*)		
Pure reinsurer		€3.2 million
Captive reinsurer		€1 million

2.1.30 ~~R~~ ~~(1)~~ ~~Subject to (2) to (3), the amount of the *base capital resources requirement* specified in the last column of the table in *GENPRU* 2.1.29R for an *insurer* 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 the case of a *mutual*, the amount of the increased *base capital resources requirement* will be three-quarters of the amount that would apply if it were not a *mutual*.~~

~~(3)~~ ~~The increase will take effect 30 days after the EU Commission has informed the European Parliament and Council of its review and the increased amount.~~

G (1) Under the *Insurance Directives* the amount of the *base capital resources requirement* specified in the last column of the table in *GENPRU* 2.1.29R for an *insurer* which is not a *non-directive insurer* is subject to annual review. The relevant amounts will be increased 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, provided that where the percentage change since the last increase is less than 5%, no increase will take place.

(2) Similar provisions for the index-linking of the *base capital resources requirement* are included in the *Reinsurance Directive*, although in that case the index-linking starts from 10 December 2005. However, to ensure consistency as between all *firms* affected by the index-linking of the *base capital resources requirement* under the *Insurance Directives* and the *Reinsurance Directive*, the *FSA* intends, so far as possible, to amend the amounts in *GENPRU* 2.1.29R for all such *firms* (and *GENPRU* 2.3.9R for the *base capital resources requirements* applying to Lloyd's) when an index-linked increase is required by the *Insurance Directives.* The *FSA* may, however, have to depart from this approach where the result would be that the *base capital resources requirement* required for any type of *firm* under *GENPRU* 2.1.29R is less than the increased amount resulting from the operation of an index-linking provision to which it is subject.

…

2.1.35 R An *insurer* must calculate its *long-term insurance capital requirement* as the sum of:

...

(2) the *insurance health risk* *and life protection reinsurance* *capital component*;

...

…

2.2 Capital resources

Application

…

Purpose

2.2.2 G (1) …

(2) *GENPRU* 2.2 also implements minimum EC standards for the composition of *capital resources* required to be held by an *insurer* undertaking business that falls within the scope of the ~~Consolidated Life Directive~~ *Consolidated Life Directive* (2002/83/EC), ~~or~~ the ~~First Non-Life Directive~~ *First Non-Life Directive* (1973/239/EEC) as amended or the *Reinsurance Directive* (2005/68/EC).

(3) …

…

2.2.77 R (1) Subject to (3), t~~T~~his *rule* applies to an *insurer* 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(1)(g) of the *Annual Accounts Directive*.

(2) …

(3) This *rule* does not apply to a *pure reinsurer* which became a *firm in run-off* before 31 December 2006 and whose *Part IV permission* has not subsequently been varied to add back the *regulated activity* of *effecting contracts of insurance*.

…

2.2.205 R For the purposes of the *capital resources table*, an *insurer* which is not a *pure reinsurer* must deduct from total *capital resources* the value of any asset which is not an *admissible asset* as listed in *GENPRU* 2 Ann 1R, unless the asset is held to cover *property-linked liabilities* or *index-linked liabilities* under *INSPRU* 3.1.57R or *INSPRU* 3.1.58R.

…

2.3 Application of GENPRU 2 to Lloyd's

Application of GENPRU 2.1

…

2.3.9 R ~~Subject to *GENPRU* 2.1.30R, the~~ The amount of the *base capital resources requirement* for the *members* in aggregate is:

(1) for *general insurance business* ~~€3 million~~ €3.2 million; and

(2) for *long term insurance business* ~~€3 million~~ €3.2 million.

…

GENPRU 2 Annex 1R
Admissible assets in insurance

(1) Investments that are, or amounts owed arising from the disposal of:

…

(2) Debts and claims

(a) debts owed by *reinsurers*, including *reinsurers'* shares of *technical provisions* (but excluding amounts recoverable from an *ISPV**);

…

(3) Other assets

…

(e) for *long-term insurance business* only, reversionary interests.

*A *firm* may treat amounts recoverable from an *ISPV* as an *admissible asset* if it obtains a *waiver* under section 148 of the *Act*. The conditions that will need to be met, in addition to the statutory tests under section 148(4) of the *Act*, before the *FSA* will consider granting such a *waiver* are set out in *INSPRU* 1.6.13G to *INSPRU* 1.6.18G.

…

TP Transitional provisions

…

13 EEA pure reinsurers

Application

13.1 R *GENPRU* TP 13 applies to a *pure reinsurer*:

(1) whose head office is in an *EEA State* other than the *United Kingdom*; and

(2) which is not an *Incoming Treaty Firm.*

Duration of transitional

13.2 R *GENPRU* TP 13 has effect in relation to a *firm* until 10 December 2008 or, if earlier, the date on which it becomes:

(1) an *Incoming EEA Firm* by reason of having exercised its right to carry on the *regulated activity* of *effecting* or *carrying out contracts of insurance* in the *United Kingdom* in accordance with Schedule 3 to the *Act* (EEA Passport Rights); or

(2) an *Incoming Treaty Firm* by reason of having exercised its right to carry on the *regulated activity* of *effecting* or *carrying out contracts*

of insurance in the *United Kingdom* in accordance with Schedule 4 to the *Act* (Treaty Rights).

Capital resources and discounting of technical provisions

13.3 R *GENPRU* 2.2.77R does not apply to a *firm*.

Annex D

INSPRU 1.6

1.6 Insurance Special Purpose Vehicles

Application and Purpose

1.6.1 R (1) *INSPRU* 1.6.4R to *INSPRU* 1.6.12R apply to a *UK ISPV*.

(2) *INSPRU* 1.6.13G to *INSPRU* 1.6.18G apply to an *insurer* which has a contract of *reinsurance* with an *ISPV*.

1.6.2 G An *ISPV* is a special purpose vehicle which assumes risks from *insurance undertakings* or *reinsurance undertakings* and which fully funds its exposure to such risks through the proceeds of a debt issuance or some other financing mechanism where the repayment rights of the providers of such debt or other financing mechanism are subordinated to the *reinsurance* obligations of that vehicle. The special feature of an *ISPV*, when compared to other *reinsurers*, is that it is fully funded to meet its *reinsurance* liabilities. It is, therefore, not subject to insurance risk to the same extent as other *reinsurers*. The *Reinsurance Directive* permits *ISPVs* to be subject to different rules to those applying to other *reinsurers*.

1.6.3 G The purpose of *INSPRU* 1.6 is:

(1) to set out the *rules* applying to *UK ISPVs* in respect of:

(a) their assets and liabilities; and

(b) their contractual arrangements; and

(2) to set out the conditions that must be met in order for an *insurer* to claim credit for *reinsurance* with an *ISPV*.

Assets and liabilities

1.6.4 R A *UK ISPV* must ensure that at all times its assets are equal to or greater than its liabilities.

1.6.5 G To satisfy the definition of an *ISPV* under the *Reinsurance Directive* the *ISPV* must be fully funded. The *FSA* considers that to be fully funded an *ISPV* must have actually received the proceeds of the debt issuance or other mechanism by which it is financed. The *FSA* would not, therefore, grant a *Part IV permission* to an *ISPV* where part of the financing for its *reinsurance* liabilities was on a contingent basis, for example, a standby facility or letter of credit.

1.6.6 G In addition to liability under its contracts of *reinsurance*, an *ISPV* will incur liability for other expenses, for example, staff and accommodation costs, *claims* handling arrangements and professional advisers' fees. *INSPRU* 1.6.4R requires a *UK ISPV* to ensure that it always has sufficient assets to meet its liabilities.

1.6.7 R A *UK ISPV* must invest its assets in accordance with the requirements set out in *INSPRU* 3.1.61AR.

1.6.8 R A *UK ISPV's* assets must be held by, or on behalf of:

(1) the *UK ISPV*; or

(2) the *insurance undertaking* or *reinsurance undertaking* which cedes to the *UK ISPV* the risks in respect of which the relevant assets are held.

Contractual arrangements

1.6.9 R A *UK ISPV* must include in each of its contracts of *reinsurance* terms which secure that its aggregate maximum liability at any time under those contracts of *reinsurance* does not exceed the amount of its assets at that time.

1.6.10 G *INSPRU* 1.6.9R requires that a *UK ISPV's* contracts of *reinsurance* should include terms that secure that its maximum *reinsurance* liability is capped at a level that is no greater than the *ISPV's* assets. In the *FSA's* view, this is a necessary condition of the *ISPV* being fully funded, as it means that the *ISPV* should not find that its assets are insufficient to meet its *reinsurance* liabilities.

1.6.11 R A *UK ISPV* must ensure that under the terms of any debt issuance or other financing arrangement used to fund its *reinsurance* liabilities the rights of the providers of that debt or other financing are fully subordinated to the claims of creditors under its contracts of *reinsurance*.

1.6.12 R A *UK ISPV* must only enter into contracts or otherwise assume obligations which are necessary for it to give effect to the *reinsurance* arrangements which represent the special purpose for which it has been established.

Reinsurance with an ISPV

1.6.13 G As a result of *GENPRU* 1.3.53AR, *GENPRU* 2 Ann 1R, *INSPRU* 1.1.92AR and *INSPRU* 1.2.28AR an *insurer* may not:

(1) treat amounts recoverable from an *ISPV* as:

(a) an *admissible asset*, or

(b) *reinsurance* for the purposes of calculating its *mathematical reserves*, or

(c) *reinsurance* reducing its *MCR*, or

(2) otherwise ascribe a value to such amounts,

unless it first obtains a *waiver* from the *FSA*. *INSPRU* 1.6.14G to *INSPRU* 1.6.18G set out the information which the *FSA* will expect to receive as part of the application for the *waiver*. Those paragraphs also set out the factors, in addition to the statutory tests under section 148 of the *Act*, to which the *FSA* will have regard in deciding:

(i) whether to grant such a *waiver* (assuming the section 148 conditions are met); and

(ii) the amount recoverable from the *ISPV* which it will allow the *insurer* to bring into account for these purposes.

1.6.14 G Where the *ISPV* is a *UK ISPV*, the *FSA* will wish to be satisfied that the *UK ISPV* complies with *INSPRU* 1.6.4R to *INSPRU* 1.6.12R. The *FSA* may rely on information supplied in connection with its application for *authorisation*. However, if the application for a *waiver* is made some time after *authorisation* was granted, the *FSA* may request confirmation that there has been no material change to the information originally supplied.

1.6.15 G Where the *ISPV* is not a *UK ISPV*, the *FSA* will expect to receive confirmation that the *ISPV* has received an official authorisation in accordance with article 46 of the *Reinsurance Directive* in the *EEA State* in which it has been established. In addition, it will need details of the debt issuance or other financing mechanism by which the *ISPV's reinsurance* liabilities are funded. The *FSA* will also expect to receive information about the *ISPV's* key management and control functions, including details of the *ISPV's* auditors and arrangements for *claims* handling, and any material *outsourcing* agreements. The *FSA* will also need information about the structure of any *group* of which the *ISPV* is a member.

1.6.16 G No credit may be taken for a contract of *reinsurance* with an *ISPV* unless the contract meets the risk transfer principle set out in *INSPRU* 1.1.19AR. The *FSA* will require evidence that the contract of *reinsurance* and the extent of the credit that the *firm* proposes to take for it satisfy the risk transfer principle.

1.6.17 G The *FSA* will require information about the impact of the *ISPV* arrangement on the ceding *firm's* individual capital assessment carried out in accordance with *INSPRU* 7.1. This should include evidence that all residual risks associated with the arrangement (including credit, market, liquidity and operational risks) are reflected in that assessment.

1.6.18 G The *FSA* will also expect to receive an analysis of the potential for risk to revert to the *firm* or any of its *associates* under realistic adverse scenarios or for liabilities to arise in respect of the risks transferred for which no provision has been made.

Annex E

Amendments to the Insurance Prudential sourcebook

In this Annex underlining indicates new text and striking through indicates deleted text. Where a block of new text is inserted, this is indicated and the new text is not underlined.

1.1 Capital resources requirements and technical provisions for insurance business

Application

…

1.1.3 R For a *non-EEA* ~~*direct*~~ *insurer* with a *branch* in the *United Kingdom* whose *insurance business* in the *United Kingdom* is not restricted to *reinsurance* (other than an *EEA-deposit insurer*, a *Swiss general insurer* or a *UK-deposit insurer*)~~,~~:

(1) the part of this section headed "Capital requirements for insurers" (*INSPRU* 1.1.43G to *INSPRU* 1.1.92BG~~91R~~) applies to its world-wide activities~~,~~;

(2) ~~whilst~~ the parts of this section headed:

(a) "Establishing technical provisions" (*INSPRU* 1.1.12R to *INSPRU* 1.1.19G)~~,~~;

(b) "Financial reinsurance and analogous non-reinsurance financing agreements: risk transfer principle" (*INSPRU* 1.1.19AR to *INSPRU* 1.1.19FG);

(c) "Assets of a value sufficient to cover technical provisions and other liabilities" (*INSPRU* 1.1.20R to *INSPRU* 1.1.29G)~~,~~;

(d) "Matching of assets and liabilities" (*INSPRU* 1.1.34R to *INSPRU* 1.1.40G); and

(e) "Premiums for new business" (*INSPRU* 1.1.41R to *INSPRU* 1.1.42G);

apply separately in respect of its world-wide activities and its activities carried on from a *branch* in the *United Kingdom*~~.~~; and

(3) ~~T~~the part of this section headed "Localisation" (*INSPRU* 1.1.30R to *INSPRU* 1.1.33R) does not apply (see *INSPRU* 1.5 (Internal contagion risk)).

1.1.4 R For an *EEA-deposit insurer* or a *Swiss general insurer*~~,~~:

(1) the parts of this section headed:

(a) "Establishing technical provisions" (*INSPRU* 1.1.12R to *INSPRU* 1.1.19G)~~,~~;

(b) "Financial reinsurance and analogous non-reinsurance financing agreements: risk transfer principle" (*INSPRU* 1.1.19AR to *INSPRU* 1.1.19FG);

(c) "Assets of a value sufficient to cover technical provisions and other liabilities" (*INSPRU* 1.1.20R to *INSPRU* 1.1.29G)~~,~~;

(d) "Matching of assets and liabilities" (*INSPRU* 1.1.34R to *INSPRU* 1.1.40G); and

(e) "Premiums for new business" (*INSPRU* 1.1.41R to *INSPRU* 1.1.42G);

apply in respect of the activities of the *firm* carried on from a *branch* in the *United Kingdom*~~.~~; and

(2) ~~T~~the parts of this section headed "Capital requirements for insurers" (*INSPRU* 1.1.43G to *INSPRU* 1.1.92BG~~91R~~) and "Localisation" (*INSPRU* 1.1.30R to *INSPRU* 1.1.33R) do not apply.

1.1.5 R For a *UK-deposit insurer*~~,~~:

(1) the part of this section headed "Capital requirements for insurers" (*INSPRU* 1.1.43G to *INSPRU* 1.1.92BG~~91R~~) applies to its world-wide activities~~,~~;

(2) ~~whilst~~ the parts of this section headed:

(a) "Establishing technical provisions" (*INSPRU* 1.1.12R to *INSPRU* 1.1.19G)~~,~~;

(b) "Financial reinsurance and analogous non-reinsurance financing agreements: risk transfer principle" (*INSPRU* 1.1.19AR to *INSPRU* 1.1.19FG);

(c) "Assets of a value sufficient to cover technical provisions and other liabilities" (*INSPRU* 1.1.20R to *INSPRU* 1.1.29G)~~,~~;

(d) "Matching of assets and liabilities" (*INSPRU* 1.1.34R to *INSPRU* 1.1.40G); and

(e) "Premiums for new business" (*INSPRU* 1.1.41R to *INSPRU* 1.1.42G);

apply separately in respect of its world-wide activities and its ~~the~~ activities ~~of the *firm*~~ carried on from *branches* in *EEA States*~~.~~; and

(3) ~~T~~the part of this section headed "Localisation" (*INSPRU* 1.1.30R to *INSPRU* 1.1.33R) does not apply (see *INSPRU* 1.5 (Internal contagion risk)).

1.1.6 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 a *non-directive mutual* ~~or a *pure reinsurer*~~.

…

Insert after *INSPRU* 1.1.19G the following new heading and *INSPRU* 1.1.19AR to *INSPRU* 1.1.19FG:

Financial reinsurance and analogous non-reinsurance financing agreements: risk transfer principle

1.1.19A R (1) A *firm* may only take credit for financial *reinsurance* if and to the extent that there has been an effective transfer of risk from the *firm* to a third party.

(2) In *INSPRU* 1.1.19AR to *INSPRU* 1.1.19FG, references to financial *reinsurance* and contracts of financial *reinsurance* include:

(a) contracts of *reinsurance* which have the characteristics of financial *reinsurance*;

(b) all contracts of *reinsurance* with an *ISPV;* and

(c) analogous non-*reinsurance* financing agreements.

1.1.19B G For the purposes of *INSPRU* 1.1.19AR(2)(c), analogous non-*reinsurance* financing agreements include contingent loans, *securitisations*, and certain financial instruments.

1.1.19C G There are a number of ways in which a *firm* may be able to take credit for financial *reinsurance* under the *rules* in *GENPRU* and *INSPRU*. Examples include:

(1) treating the *reinsurer's* share of *technical provisions* as an *admissible asset* in accordance with *GENPRU* 2 Ann 1R;

(2) reducing its solvency requirements in accordance with the deduction for *reinsurance* allowed in the calculation of the *general insurance capital requirement* or the *long-term insurance capital requirement* under *INSPRU* 1.1; and

(3) bringing into account amounts receivable under the contract when valuing cash flows for the purpose of a prospective valuation of *mathematical reserves* under *INSPRU* 1.2. In particular, a contingent loan or other analogous non-*reinsurance* financing agreement may then give rise to an addition to *capital resources* as a positive valuation difference in accordance with *GENPRU* 2.2.75R.

1.1.19D G The amount of credit taken by a *firm* for a risk transferred should be measured by applying the standard methods for determining the regulatory balance sheet set out in *INSPRU*. For example, where credit is being taken so as to reduce *technical provisions*, the amount of that credit should reflect the difference in *technical provisions* that arises from changing the assumptions used to reflect the risk transferred.

1.1.19E G For the purposes of *INSPRU* 1.1.19AR(1), the transfer of risk from the *firm* to the third party should be effective in all circumstances in which the *firm* may wish to rely upon the transfer. Examples of factors which the *firm* should take into account in assessing whether the transaction effectively transfers risk and the extent of that transfer include:

(1) whether the documentation associated with the financial *reinsurance* reflects the economic substance of the transaction;

(2) whether the extent of the risk transfer is clearly defined and incontrovertible;

(3) whether the transaction contains any terms or conditions, the fulfilment of which is outside the direct control of the *firm*. Such terms or conditions may include those which:

(a) would allow the third party unilaterally to cancel the transaction, except for the non-payment of monies due from the *firm* to the third party under the contract; or

(b) would increase the effective cost of the transaction to the *firm* in response to an increased likelihood of the third party experiencing losses under the transaction; or

(c) would oblige the *firm* to alter the risk that had been transferred with the purpose of reducing the likelihood of the third party experiencing losses under the transaction; or

(d) would allow for the termination of the transaction due to an increased likelihood of the third party experiencing losses under the transaction; or

(e) could prevent the third party from being obliged to pay out in a timely manner any monies due under the transaction; or

(f) could allow the maturity of the transaction to be reduced;

(4) whether the transaction is legally effective and enforceable in all relevant jurisdictions.

1.1.19F G A *firm* should also take into account circumstances in which the benefit to the *firm* of the transfer of risk could be undermined. For instance, where the *firm*, with a view to reducing potential or actual losses to third parties, provides support to the transaction, including support beyond its contractual obligations (implicit support). Another example of a situation where the *firm* should consider whether it should take reduced credit for a transaction is where it has invested in the bonds issued by an *ISPV* with which it has reinsured risks.

…

Matching of assets and liabilities

1.1.34 R …

(4) (1) does not apply to:

(a) a *pure reinsurer*; or

(b) 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.

1.1.34A G *INSPRU* 1.1.34R is not applied to *pure reinsurers* because they are subject under *INSPRU* 3.1.61AR to the "prudent person" investment principles from the *Reinsurance Directive*.

…

1.1.45 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~~ 53.1 million; multiplied by

…

…

1.1.47 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~~ 37.2 million; multiplied by

…

…

1.1.49 ~~R~~ ~~(1)~~ ~~Subject to (2) and (3), the Euro amounts specified in *INSPRU* 1.1.45R(1) and *INSPRU* 1.1.47R(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.~~

G (1) Under the *Insurance Directives* the Euro amounts specified in *INSPRU* 1.1.45R(1) and *INSPRU* 1.1.47R(1) are subject to annual review. The relevant amounts will be increased 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, provided that where the percentage change since the last increase is less than 5%, no increase will take place.

(2) No provision for the index-linking of these amounts is made by the *Reinsurance Directive*. However, to ensure consistency as between *pure reinsurers*, *mixed insurers* and other *insurers*, the *FSA* intends to amend the Euro amounts specified in *INSPRU* 1.1.45R(1) and *INSPRU* 1.1.47R(1) for all such *firms* when an index-linked increase is required by the *Insurance Directives.*

…

1.1.54 R …

1.1.54A G For the treatment of amounts recoverable from *ISPVs* when calculating the reinsurance ratio, see *INSPRU* 1.1.92AR and *INSPRU* 1.1.92BG.

…

1.1.56 R For the purpose of *INSPRU* 1.1.45R, the *gross adjusted premiums amount* is the higher of the *gross written premiums* and *gross earned premiums* (as adjusted in accordance with *INSPRU* 1.1.66R) for the *financial year in question*, adjusted by:

(1) except for a *pure reinsurer* which became a *firm in run-off* before 31 December 2006 and whose *Part IV permission* has not subsequently been varied to add back the *regulated activity* of *effecting contracts of insurance* ~~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;

…

…

1.1.60 R For the purpose of *INSPRU* 1.1.47R and subject to *INSPRU* 1.1.62R, the *gross adjusted claims amount* is the amount of gross *claims* incurred (as determined in accordance with *INSPRU* 1.1.66R) over the reference period (as specified in *INSPRU* 1.1.63R) and adjusted by:

(1) except for a *pure reinsurer* which became a *firm in run-off* before 31 December 2006 and whose *Part IV permission* has not subsequently been varied to add back the *regulated activity* of *effecting contracts of insurance* ~~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;

…

…

Long-term insurance capital requirement

1.1.80 G … *GENPRU* 2.1.35R defines the *LTICR* as the sum of the *insurance death risk*, *health risk and life protection reinsurance*, *expense risk*, and *market risk capital components* (see *INSPRU* 1.1.81R to *INSPRU* 1.1.91R). *Rules* and *guidance* about the *resilience capital requirement* are set out in *INSPRU* 3.1.9G to *INSPRU* 3.1.26R.

Insurance death risk capital component

…

1.1.83 R …

less, in either case, the *mathematical reserves* for the contract.

1.1.83A R *INSPRU* 1.1.81R does not apply to:

(1) a *pure reinsurer*; or

(2) a *mixed insurer*;

in respect of *life protection reinsurance business*.

1.1.84 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) which also applies to the risk of death covered in the *life protection reinsurance business* of *pure reinsurers* and *mixed insurers*. *Tontines* (*class* V) and *capital redemption* operations (*class* VI) also have separate risk components. There is no specified risk margin for other insured risks.

1.1.84A G For the treatment of amounts recoverable from *ISPVs* when calculating the *insurance death risk capital component* in accordance with *INSPRU* 1.1.81R, see *INSPRU* 1.1.92AR and *INSPRU* 1.1.92BG.

Insurance health risk and life protection reinsurance capital component

1.1.85 R ...

in respect of:

(a) *contracts of insurance* falling in *long-term insurance business class* IV (see *INSPRU* 1.1.86R); ~~and~~

(b) risks falling in *general insurance business classes* 1 or 2 that are written as part of a *long-term insurance contract*~~.~~; and

(c) in the case of a *pure reinsurer* or a *mixed insurer*, *life protection reinsurance business*.

...

1.1.87 G The *insurance health risk and life protection reinsurance capital component* only ~~arises for~~ applies to *permanent health* insurance (*long-term insurance business class* IV), ~~and~~ *accident* and *sickness* insurance (*general insurance business classes* 1 and 2) and the *life protection reinsurance business* of *pure reinsurers* and *mixed insurers*.

Insurance expense risk capital component

1.1.88 R …

1.1.88A R *INSPRU* 1.1.88R does not apply to:

(1) a *pure reinsurer*; or

(2) a *mixed insurer*;

in respect of:

(a) *life protection reinsurance business*; or

(b) *permanent health reinsurance business*.

Insurance market risk capital component

1.1.89 R The *insurance market risk capital component* is 3% of the "adjusted *mathematical reserves*" (as defined in *INSPRU* 1.1.89AR) for all insurance liabilities except those of a kind which:

(1) arise from *contracts of insurance* falling in *long-term insurance business classes* III, VII or VIII to the extent that the *firm* does not bear any investment risk; or

(2) arise from *contracts of insurance* falling in *long-term insurance business class* V~~.~~; or

(3) for a *pure reinsurer* or a *mixed insurer*, arise from *reinsurance* acceptances in respect of:

(a) *contracts of insurance* falling within *long-term insurance business class* I that are not annuities or *with-profits insurance contracts*; or

(b) *contracts of insurance* falling within *long-term insurance business class* IV.

…

1.1.92 G …

Insurance special purpose vehicles

1.1.92A R A *firm* must not treat any amounts recoverable from an *ISPV* as *reinsurance* for the purposes of the calculation of:

(1) the reinsurance ratio in accordance with *INSPRU* 1.1.54R; or

(2) the *insurance death risk capital component* in accordance with *INSPRU* 1.1.81R; or

(3) the "adjusted *mathematical reserves*" in accordance with *INSPRU* 1.1.90R.

1.1.92B G A *firm* may treat amounts recoverable from an *ISPV* as *reinsurance* for these purposes if it obtains a *waiver* of *INSPRU* 1.1.92AR under section 148 of the *Act*. The conditions that will need to be met, in addition to the statutory tests under section 148(4) of the *Act*, before the *FSA* will consider granting such a *waiver* are set out in *INSPRU* 1.6.13G to *INSPRU* 1.6.18G.

…

Contracts not to be treated as assets

1.2.24 R (1) A *firm* must not treat a *long-term insurance contract* as an asset.

(2) (1) does not apply to a *pure reinsurer* in respect of *contracts of insurance*:

(a) falling within *long-term insurance business class* I (other than annuities and *with-profits insurance contracts*); or

(b) falling within *long-term insurance business class* IV.

(3) Notwithstanding (2), the total *mathematical reserves* established by a *pure reinsurer* must have a minimum value of at least zero.

1.2.25 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 *Consolidated Life 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. But the *Reinsurance Directive* does not require that this treatment is applied to *pure reinsurers*. *Pure reinsurers* may therefore treat as an asset a contract written as part of carrying on *life protection reinsurance business* or *permanent health reinsurance business* provided that this is based on assumptions which meet the general requirements for prudent assumptions as set out in *INSPRU* 1.2.10R and *INSPRU* 1.2.13R. This does not, however, allow a *pure reinsurer* to establish total *mathematical reserves* which are negative.

…

Cash flows to be valued

1.2.28 R In a prospective valuation, a *firm* must:

(1) include ~~the following~~ in the cash flows to be valued the following:

(~~1~~a) …

(~~2~~b) …

(~~3~~c) …

(~~4~~d) subject to (2), amounts to be received or paid in respect of the *long-term insurance contracts* under contracts of *reinsurance* or analogous non-*reinsurance* financing agreements (see *INSPRU* 1.2.77AR to *INSPRU* 1.2.89G)~~.~~; but

(2) exclude from those cash flows amounts recoverable from an *ISPV*.

1.2.28A G A *firm* may include amounts recoverable from an *ISPV* in the cash flows to be valued in a prospective valuation if it obtains a *waiver* of *INSPRU* 1.2.28R under section 148 of the *Act*. The conditions that will need to be met, in addition to the statutory tests under section 148(4) of the *Act*, before the *FSA* will consider granting such a *waiver* are set out in *INSPRU* 1.6.13G to *INSPRU* 1.6.18G.

…

Persistency assumptions

1.2.73 G *INSPRU* 1.2.76R and *INSPRU* 1.2.77G apply to the valuation of the *with-profits insurance liabilities* of *realistic basis life firms*. *INSPRU* 1.2.76AR and *INSPRU* 1.2.77G apply to the valuation of liabilities arising from the *life protection reinsurance business* and *permanent health reinsurance business* of *pure reinsurers*. *INSPRU* 1.2.74R and *INSPRU* 1.2.75G apply to the valuation of all other liabilities.

1.2.74 R Except as permitted by *INSPRU* 1.2.76R and *INSPRU* 1.2.76AR, 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.

…

1.2.76 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 *INSPRU* 1.2.10R and *INSPRU* 1.2.13R.

1.2.76A R A *pure reinsurer* may make assumptions about voluntary discontinuance rates in the calculation of the *mathematical reserves* in respect of *contracts of insurance* falling within:

(1) *long-term insurance business class* I (other than annuities and *with-profits insurance contracts*); or

(2) *long-term insurance business class* IV;

provided that those assumptions meet the general requirements for prudent assumptions as set out in *INSPRU* 1.2.10R and *INSPRU* 1.2.13R.

…

1.4.2 G The scope of *INSPRU* 1.4.11R to *INSPRU* 1.4.37G (non-credit equalisation provisions) is not restricted to *firms* subject to the relevant EC directives. ~~It applies, for example, to *pure reinsurers*.~~

…

1.4.7G

Table : Scope of *insurance business* to be included in calculations				
Type Of Firm		Credit Equalisation Provision		Non Credit Equalisation Provision
		Threshold in *INSPRU* 1.4.44R	Provision in *INSPRU* 1.4.43R	Threshold in *INSPRU* 1.4.18R(2) and provision in *INSPRU* 1.4.17R
UK insurer		World-wide	World-wide	World-wide
Pure reinsurer with head office outside *United Kingdom*		~~*INSPRU* 1.4.39R to *INSPRU* 1.4.47G do not apply~~ *UK*	World-wide	*UK*
Pure reinsurer with head office in *United Kingdom*		~~*INSPRU* 1.4.39R to *INSPRU* 1.4.47G do not apply~~ World-wide	World-wide	World-wide
Non-EEA direct insurers	*EEA-deposit insurer*	*UK*	*UK*	*UK*
	Swiss general insurer	*UK*	*UK*	*UK*
	UK-deposit insurer	All *EEA*	World-wide	*UK*
	All other *non-EEA direct insurers*	*UK*	World-wide	*UK*

1.4.8 G The *First Non-Life Directive* (as amended) and the *Reinsurance Directive* require~~s~~ 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.

…

Firms carrying on credit insurance business

1.4.38 R *INSPRU* 1.4.39R to *INSPRU* 1.4.47G apply to any *firm*~~:~~

~~(1) any *UK insurer*; and~~

~~(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 (which business~~, excluding contracts of *reinsurance*,~~ is referred to in *INSPRU* 1.4 as "credit *insurance business*"), unless it is:

(1) a *non-directive insurer*; or

(2) a *pure reinsurer* which became a *firm in run-off* before 31 December 2006 and whose *Part IV permission* has not subsequently been varied to add back the *regulated activity* of *effecting contracts of insurance*.

1.4.39 R For the purposes of *INSPRU* 1.4.43R and *INSPRU* 1.4.44R, a ~~*UK insurer*~~ *firm* whose head office is in the *United Kingdom* must take account of the credit *insurance business* carried on by it world-wide.

1.4.40 R (1) For the purposes of *INSPRU* 1.4.43R:

(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*; and

(b) any other *firm* whose head office is outside the *United Kingdom* (including a *UK-deposit insurer*) must take account of the credit *insurance business* carried on by it world-wide.

(2) For the purposes of *INSPRU* 1.4.44R:

(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*~~ *firm* whose head office is outside the *United Kingdom* (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*.

1.4.41 G For ~~*UK insurers* the~~ *firms* whose head office is in the *United Kingdom* both calculations must be made in respect of world-wide business.

…

1.4.43	R	In respect of each *financial year*, a ~~*UK insurer* or a *non-EEA direct insurer*~~ *firm* must, unless *INSPRU* 1.4.44 R applies…
1.4.44	R	*INSPRU* 1.4.43 R does not apply to ~~any *UK insurer* or a *non-EEA direct insurer*~~ a *firm* in respect of any *financial year* if…
1.4.45	R	(1) The amount of a ~~*UK insurer's*, or a *non-EEA direct insurer's*,~~ *firm's* *credit equalisation provision* as at the end of a *financial year*...

…

1.5.3	G	The scope of application of *INSPRU* 1.5 is not restricted to *firms* that are subject to the relevant EC directives. ~~It applies, for example, to *pure reinsurers*.~~

…

1.5.10	G	This section requires *firms* other than *pure reinsurers* 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. *Pure reinsurers* must limit their activities to the business of *reinsurance* and related operations.

…

		Restriction of business ~~to insurance~~
1.5.13	R	(1) A *firm* other than a *pure reinsurer* must not carry on any commercial business other than *insurance business* and activities directly arising from that business.
		(2) …
1.5.13A	R	A *pure reinsurer* must not carry on any business other than the business of *reinsurance* and related operations.
1.5.13B	G	In *INSPRU* 1.5.13AR related operations include, for example, activities such as provision of statistical or actuarial advice, risk analysis or research for its clients. It may also include a *holding company* function and activities with respect to financial sector activities within the meaning of Article 2, point 8, of the *Financial Groups Directive*. But it does not allow the carrying on of, for example, unrelated banking and financial activities.

…

2.1.3 G The scope of application of *INSPRU* 2.1 is not restricted to *firms* that are subject to relevant EC directives. ~~It applies, for example, to *pure reinsurers*.~~

…

Market risk and counterparty limits

2.1.22 R …

2.1.22A R *INSPRU* 2.1.22R does not apply to a *pure reinsurer*.

…

2.2.2 G The scope of application of *INSPRU* 2.2 is not restricted to *firms* that are subject to the relevant EC directives. ~~It applies, for example, to *pure reinsurers*.~~

…

3.1.2 G ~~The scope of application of *INSPRU* 3.1 is not restricted to *firms* that are subject to the relevant EC directives. It applies, for example, to *pure reinsurers* (with the exception of *INSPRU* 3.1.53R).~~ *INSPRU* 3.1 applies to *pure reinsurers*, with the exception of *INSPRU* 3.1.53R, *INSPRU* 3.1.57R and *INSPRU* 3.1.58R.

…

3.1.7 G *INSPRU* 3.1 addresses the impact of *market risk* on *insurance business* in the ways set out below:

...

(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. *INSPRU* 3.1.57R and *INSPRU* 3.1.58R set out these cover requirements.

(6) The *Reinsurance Directive* applies to *pure reinsurers* "prudent person" investment principles in relation to the investment of their assets. *INSPRU* 3.1.61AR sets out these principles.

…

Covering linked liabilities

...

3.1.58 R …

3.1.58A R *INSPRU* 3.1.57R and *INSPRU* 3.1.58R do not apply to a *pure reinsurer*.

…

3.1.61 G …

Pure reinsurers

3.1.61A R A *pure reinsurer* must invest its assets in accordance with the following requirements:

(1) the assets must take account of the type of business carried out by the *firm*, in particular the nature, amount and duration of expected *claims* payments, in such a way as to secure the sufficiency, liquidity, security, quality, profitability and matching of its investments;

(2) the *firm* must ensure that the assets are diversified and adequately spread and allow the *firm* to respond adequately to changing economic circumstances, in particular developments in the financial markets and real estate markets or major catastrophic events; the *firm* must assess the impact of irregular market circumstances on its assets and must diversify the assets in such a way as to reduce such impact;

(3) investment in assets which are not admitted to trading on a *regulated market* must be kept to prudent levels;

(4) investment in *derivatives* and *quasi-derivatives* must contribute to a reduction of investment risks or facilitate efficient portfolio management and such investments must be valued on a prudent basis, taking into account the underlying assets, and included in the valuation of the *firm's* assets. The *firm* must avoid excessive risk exposure to a single *counterparty* and to other *derivative* or *quasi-derivative* operations;

(5) the assets must be properly diversified in such a way as to avoid:

(a) excessive reliance on any one particular asset, *issuer* or *group* of *undertakings*; and

(b) accumulations of risk in the portfolio as a whole.

Investments in assets issued by the same *issuer* or by *issuers* belonging to the same *group* must not expose the *firm* to excessive risk concentration; and

(6) (5) does not apply to investment in government bonds.

…

3.2 Derivatives in insurance

Application

3.2.1 R This section applies to an *insurer*, unless it is:

(1) a *non-directive friendly society*; or

(2) an *incoming EEA firm*; or

(3) an *incoming Treaty firm*; or

(4) a *pure reinsurer*.

3.2.2 G The scope of application of *INSPRU* 3.2 is not restricted to *firms* that are subject to the relevant EC directives. ~~It applies, for example, to *pure reinsurers*.~~

…

6.1.1 R *INSPRU* 6.1 applies to an *insurer* that is either:

(1) a *participating insurance undertaking*; or

(2) a member of an *insurance group* which is not a *participating insurance undertaking* and which is not:

~~(a) a *pure reinsurer*; or~~

(~~b~~a) a *non-EEA insurer*; or

(~~c~~b) a *friendly society*.

…

6.1.4 G For the purposes of *INSPRU* 6.1, an *insurer* includes ~~a *pure reinsurer*~~, a *friendly society* (other than a *non-directive friendly society*) and a *non-EEA insurer*.

Purpose

6.1.5 G The purpose of this section is to implement the *Insurance Groups Directive* on supplementary supervision of *firms* in an *insurance group*, as amended by the *Financial Groups Directive* and the *Reinsurance Directive*. The *Financial Groups Directive* (by amending the *Insurance Directives* and the *Insurance Groups Directive*) introduces specific requirements for the treatment of *related undertakings* of an *insurance parent undertaking* or a *participating insurance undertaking* that are *credit institutions, investment firms* or *financial institutions*. The *Reinsurance Directive* (by amending the *Insurance Directives* and the *Insurance Groups Directive*) introduces supplementary supervision for *firms* that are *reinsurance undertakings* in an *insurance group*.

…

Scope - undertakings whose group capital is to be calculated and maintained

6.1.17 R The *undertakings* referred to in *INSPRU* 6.1.8R, *INSPRU* 6.1.9R, *INSPRU* 6.1.10R and *INSPRU* 6.1.15R are:

(1) …

(2) the *firm* itself, where the *firm* is a *participating insurance undertaking* and is:

~~(a)~~ ~~a *pure reinsurer*; or~~

(~~b~~a) a *non-EEA insurer*; or

(~~c~~b) a *friendly society*.

…

6.1.34 R For the purposes of *INSPRU* 6.1, an *individual capital resources requirement* is:

(1) in respect of any *insurer* ~~that is not within (2)~~:

(a) …

(b) …

~~(2)~~ ~~in respect of an *insurer* that is either a *pure reinsurer* or whose main business otherwise consists of *reinsurance*, and whose head office is in the *United Kingdom*, the *capital resources requirement* that would apply to the *firm* in accordance with *GENPRU* 2.1 if its *insurance business* was not restricted to *reinsurance*;~~

(~~3~~2) in respect of an *insurance undertaking* that is not within (1) ~~or (2) and whose main business is *reinsurance*~~ and whose head office is in a *designated State or territory*, either:

(a) its~~the~~ *proxy capital resources requirement* ~~that would apply to it if, in connection with its *reinsurance* activities, the *permissions* on the basis of which that *proxy capital resources requirement* is calculated were *permissions* to carry on *insurance business* that is not restricted to~~

~~*reinsurance*~~; or

(b) the solo capital resources requirement that ~~would apply~~ applies to it ~~if, in connection with its *reinsurance* activities, the *insurance undertaking* were a *regulated insurance entity* whose *insurance business* is not restricted to *reinsurance* for the purposes of the calculation of its capital resources requirement in accordance with the relevant~~ under the *sectoral rules* for the *insurance sector* of the *designated State or territory*;

~~(4) in respect of an *insurance undertaking* that is not within (1) to (3) and whose main business is *reinsurance*, the *proxy capital resources requirement* that would apply to it if, in connection with its *reinsurance* activities, the *permissions* on the basis of which that *proxy capital resources requirement* is calculated were *permissions* to carry on *insurance business* that is not restricted to *reinsurance*;~~

(3) in respect of an *insurance undertaking* within (2) which is not subject to a solo capital resources requirement under the *sectoral rules* for the *insurance sector* of that *designated State or territory*, its *proxy capital resources requirement*;

(~~5~~4) in respect of an *EEA insurer* (other than an *EEA pure reinsurer*), the equivalent of the *capital resources requirement* as calculated in accordance with the applicable requirements in its *Home State*;

(5) in respect of an *EEA pure reinsurer*, the equivalent of the *capital resources requirement* as calculated in accordance with the applicable requirements in its *Home State*;

~~(6) in respect of an *insurance undertaking* that is not within (1) to (5) and whose head office is in a *designated State or territory*, either:~~

~~(a) the capital resources requirement applicable to it under the *sectoral rules* for its *financial sector* in that *designated State or territory*; or~~

~~(b) its *proxy capital resources requirement*;~~

(~~7~~6) in respect of an *insurance undertaking* that is not within (1) to (~~6~~5), its *proxy capital resources requirement*;

(~~8~~7) in respect of an *insurance holding company*, zero;

(~~9~~8) [intentionally blank]

(~~10~~ 9) in respect of a *regulated entity* (excluding an *insurance undertaking*), its *solo capital resources requirement*;

(~~11~~ 10) in respect of an *asset management company*, the *solo capital resources requirement* that would apply to it if, in connection with its activities, it were treated as being in the *investment services sector*;

(~~12~~ 11) in respect of a *financial institution* that is not a *regulated entity* (including a *financial holding company*), the *solo capital resources requirement* that would apply to it if, in connection with its activities, it were treated as being within the *banking sector*; and~~.~~

(12) in respect of an *EEA ISPV*, the solo capital resources requirement that applies to the *ISPV* under the *sectoral rules* for the *insurance sector* of the *Member State* of the *competent authority* that authorised the *ISPV*.

6.1.34A G For the purposes of *INSPRU* 6.1.34R(2~~3~~)(b) ~~and (6)(a)~~, where the solo capital resources requirement under the *sectoral rules* for the *insurance sector* in a *designated State or territory* is ascertained by reference to the trigger for regulatory intervention, the *FSA* considers that the solo capital resources requirement of the *insurance undertaking* in such a *designated State or territory* will generally correspond to the highest point at which any regulatory or corrective action is triggered or which is at least comparable ~~in effect most nearly equivalent~~ to the *capital resources requirement* which would apply if the *insurance undertaking* were an *insurer*.

6.1.35 G [intentionally blank]~~The *Insurance Groups Directive* defines reinsurers in terms of the 'main business' they carry on. Under the directive, the individual capital resources requirements for reinsurers (including those whose head office is in the *United Kingdom*) are to be calculated on the basis of requirements analogous to those applicable to direct insurers (that is, *insurers* carrying on insurance business that is not restricted to *reinsurance*). Although *insurers* that are *pure reinsurers* are already subject to *INSPRU*, there are a number of respects in which the capital regime that applies to them differs from that applicable to *insurers* who are direct insurers. The effect of *INSPRU* 6.1.34R (2) to (4) is to calculate the *individual capital resources requirement* for all reinsurers as if they were carrying on direct insurance. This applies to:~~

~~(1) pure reinsurers whose head office is in the United Kingdom;~~

~~(2) insurers whose head office is in the United Kingdom and whose main business is reinsurance (because an insurer that is not a pure reinsurer with their business restricted to reinsurance may nevertheless in principle still have reinsurance as its main business);~~

~~(3) reinsurers whose head office is in another EEA State;~~

~~(4) reinsurers whose head office is in a designated State or territory (other than an EEA State); and~~

~~(5) reinsurers whose head office is outside the EEA.~~

…

6.1.38 R For the purposes of *INSPRU* 6.1.37R, the *sectoral rules* applicable to:

(1) an *insurance holding company* whose main business is to acquire and hold participations in *subsidiary undertakings* which are either exclusively or mainly *reinsurance undertakings* are the *sectoral rules* that would apply to it if, in connection with its activities, it were treated as ~~an *insurer*~~ a *pure reinsurer*;

(2) an *insurance holding company* not within (1) are the *sectoral rules* that would apply to it if, in connection with its activities, it were treated as an *insurer*;

(~~2~~3) an *asset management company* are the *sectoral rules* that would apply to it if, in connection with its activities, it were treated as an *investment firm*; and

(~~3~~4) subject to *INSPRU* 6.1.39R, a *financial institution*, that is not a *regulated entity*, are the *sectoral rules* that would apply to it if, in connection with its activities, it were treated as being within the *banking sector*.

…

6.1.42 R …

6.1.42A R For the purposes of calculating *group capital resources*, a *firm* must exclude the book value of any investment by a *related undertaking* of the *undertaking* in *INSPRU* 6.1.17R in shares of, or loans to, an *undertaking* that is not a *related undertaking*, where that *undertaking* has invested in the *capital resources* of a *regulated related undertaking* of the *undertaking* in *INSPRU* 6.1.17R.

…

6.1.60 R For the purposes of *INSPRU* 6.1.59R, an asset is not an admissible asset if:

(1) in respect of a *regulated related undertaking* or *undertaking* in *INSPRU* 6.1.17R that is an *insurer* (other than a *pure reinsurer*), it is not an *admissible asset* as listed in *GENPRU* 2 Annex 1R;

(2) in respect of a *regulated related undertaking* or *undertaking* in *INSPRU* 6.1.17R that is a *pure reinsurer*, it does not comply with *INSPRU* 3.1.61AR; or

(~~2~~3) in respect of a *regulated related undertaking* or *undertaking* in *INSPRU* 6.1.17R that is not an *insurer*, it is an asset of the *undertaking* that is not admissible for the purpose of calculating that *undertaking's solo capital resources* in accordance with the *sectoral rules* applicable to it.

6.1.61 R For the purposes of *INSPRU* 6.1.60R(~~2~~3), the *sectoral rules* applicable to:

…

…

6.1.70 R Subject to *INSPRU* 6.1.70AR, w~~W~~here the *undertaking* in *INSPRU* 6.1.17R is a *participating insurance undertaking*, the *firm* must deduct from its group capital resources before deduction (calculated at stage C in the table in *INSPRU* 6.1.43R) the assets in excess of *market risk* and *counterparty* exposure limits calculated in accordance with *INSPRU* 6.1.74R.

6.1.70A R Where the *undertaking* in *INSPRU* 6.1.17R is a *pure reinsurer* that is a *participating insurance undertaking*, the *firm* must calculate assets in accordance with *INSPRU* 6.1.74AR and deduct from its group capital resources before deduction (calculated at stage C in the table in *INSPRU* 6.1.43R) those assets that do not comply with *INSPRU* 3.1.61AR.

…

6.1.72 R The *firm* (A) must, subject to *INSPRU* 6.1.73R, include in the calculation in *INSPRU* 6.1.74R or, where A is a *pure reinsurer*, *INSPRU* 6.1.74AR each *related undertaking* (B) that is:

…

6.1.73 R The *related undertakings* in *INSPRU* 6.1.72R need only be included in the calculation in *INSPRU* 6.1.74R or *INSPRU* 6.1.74AR if:

…

6.1.74 R A's assets in excess of the *market risk* and *counterparty* exposure limits are calculated as follows:

(1) …

(a) …

(b) where B is a *pure reinsurer*, the assets of that *undertaking* less those assets identified in *INSPRU* 6.1.60R(2) as not being admissible; and

(~~b~~c) where B is a *regulated related undertaking* that is not an *insurer*, the assets of that *undertaking* less those assets identified in *INSPRU* 6.1.60R(~~2~~3) as not being admissible assets.

…

(4) After the application of (1) and (2), the surplus assets of B are

aggregated with the *admissible assets* of A, where the surplus assets of B are:

(a) where B is a *firm* (other than a *pure reinsurer*), the *admissible assets* of B that represent the amount by which the *capital resources* of B exceed its *capital resources requirement*, subject to *INSPRU* 6.1.77R, and limited to the amount of transferable capital calculated in accordance with *INSPRU* 6.1.68R;

(b) where B is a *regulated related undertaking* that is not in (a)~~a *firm*~~, the assets of the *undertaking* in *INSPRU* 6.1.74R(1)(b) or (c) that represent the amount by which the *solo capital resources* of B exceed its *individual capital resources requirement* and, where B is an *insurance undertaking* that is not in (a)~~a *firm*~~, limited to the amount of transferable capital calculated in accordance with *INSPRU* 6.1.68R; and

…

…

6.1.74A R A must apply *INSPRU* 3.1.61AR to the aggregate of:

(1) the assets of A, less any assets already identified in *INSPRU* 6.1.60R(2) as not being admissible; and

(2) the surplus assets of B calculated in accordance with *INSPRU* 6.1.74R(1) to (4) as if that *rule* applied to B.

6.1.75 R (1) Subject to (2), ~~The *firm* (~~A~~)~~ must then deduct the amount by which the *admissible assets* aggregated in accordance with *INSPRU* 6.1.74R(5) exceed the *market risk* and *counterparty* exposure limits from A's group capital resources before deduction (calculated at stage C in the table in *INSPRU* 6.1.43R) in accordance with *INSPRU* 6.1.70R.

(2) Where A is a *pure reinsurer*, A must then deduct the amount of any assets identified by *INSPRU* 6.1.74AR as not complying with *INSPRU* 3.1.61AR in accordance with *INSPRU* 6.1.70AR.

…

6.1.77 R The *admissible assets* of either A or B that are part of a *long-term insurance fund* of A or B are excluded for the purposes of the calculation in *INSPRU* 6.1.74R and *INSPRU* 6.1.74AR except insofar as those assets are available to meet the liabilities and *capital resources requirement* of that *long-term insurance fund*.

INSPRU TP

Transitional provisions

…

4 EEA pure reinsurers

Application

4.1 R *INSPRU* TP 4 applies to a *pure reinsurer*:

(1) whose head office is in an *EEA State* other than the *United Kingdom*; and

(2) which is not an *Incoming Treaty Firm*.

Duration of transitional

4.2 R *INSPRU* TP 4 has effect in relation to a *firm* until 10 December 2008 or, if earlier, the date on which it becomes:

(1) an *Incoming EEA Firm* by reason of having exercised its right to carry on the *regulated activity* of *effecting* or *carrying out contracts of insurance* in the *United Kingdom* in accordance with Schedule 3 to the *Act* (EEA Passport Rights); or

(2) an *Incoming Treaty Firm* by reason of having exercised its right to carry on the *regulated activity* of *effecting* or *carrying out contracts of insurance* in the *United Kingdom* in accordance with Schedule 4 to the *Act* (Treaty Rights).

50% premiums and claims uplift for classes 11, 12 and 13; credit equalisation provision

4.3 R The following *rules* or paragraphs of a *rule* do not apply to a *firm*:

(1) *INSPRU* 1.1.56R(1);

(2) *INSPRU* 1.1.60R(1); and

(3) *INSPRU* 1.4.39R to *INSPRU* 1.4.46R.

Annex F

Amendments to the Interim Prudential sourcebook for Insurers

In this Annex underlining indicates new text and striking through indicates deleted text.

…

APPENDIX 9.1 (rules 9.12 and 9.13)

BALANCE SHEET AND PROFIT AND LOSS ACCOUNT
(FORMS 1 TO 3 AND 10 TO 19)

...

Calculation of general insurance capital requirement– premiums amount and brought forward amount **Form 11**

Name of insurer
Global business / UK branch business / EEA branch business
Financial year ended
General/long-term insurance business

	Company registration number	GL/ UK/ CM	day	month	year	units
R11						£000

			This financial year 1	Previous year 2
Gross premiums written		11		
Premium~~s~~ taxes and levies (included in line 11)		12		
Premiums ~~receivable~~ written net of taxes and levies (11-12)		13		
Premiums for classes 11, 12 or 13 (included in line 13)		14		
Premiums for "actuarial health insurance" (included in line 13)		15		
Sub-total A (13 + ½ 14 - $^{2}/_{3}$ 15)		16		
Gross premiums earned		21		
Premium taxes and levies (included in line 21)		22		
Premiums earned net of taxes and levies (21-22)		23		
Premiums for classes 11, 12 or 13 (included in line 23)		24		
Premiums for "actuarial health insurance" (included in line 23)		25		
Sub-total H (23 + ½ 24 - $^{2}/_{3}$ 25)		26		
Sub-total I (higher of sub-total A and sub-total H)		30		
Adjusted sub-total I if financial year is not a 12 month period to produce an annual figure		31		
Division of gross adjusted premiums amount: sub-total I (or adjusted sub-total I if appropriate)	x 0.18	32		
	Excess (if any) over ~~50~~53.1M EURO x 0.02	33		
Sub-total J (32-33)		34		
Claims paid in period of 3 financial years		41		
Claims outstanding carried forward at the end of the 3 year period	For insurance business accounted for on an underwriting year basis	42		
	For insurance business accounted for on an accident year basis	43		
Claims outstanding brought forward at the beginning of the 3 year period	For insurance business accounted for on an underwriting year basis	44		
	For insurance business accounted for on an accident year basis	45		
Sub-total C (41+42+43-44-45)		46		
Amounts recoverable from reinsurers in respect of claims included in Sub-total C		47		
Sub-total D (46-47)		48		
Reinsurance ratio (Sub-total D / sub-total C or, if more, ~~50%~~ 0.50 or, if less, ~~100%~~ 1.00)		49		
Premiums amount (Sub-total J x **reinsurance ratio**)		50		
Provision for claims outstanding (before discounting and net of reinsurance)		51		
Brought forward amount (12.43.2 x 51.1 / 51.2 or, if less, 12.43.2)		52		
Greater of lines 50 and 52		53		

…

Calculation of general insurance capital requirement– claims amount and result **Form 12**

Name of insurer
Global business / UK branch business / EEA branch business
Financial year ended
General/long-term insurance business

	Company registration number	GL/ UK/ CM	day	month	year	units
R12						£000

			This financial year 1	Previous year 2
Reference period (No. of months) See *PRU* 7.2.63R		11		
Claims paid in reference period		21		
Claims outstanding carried forward at the end of the reference period	For insurance business accounted for on an underwriting year basis	22		
	For insurance business accounted for on an accident year basis	23		
Claims outstanding brought forward at the beginning of the reference period	For insurance business accounted for on an underwriting year basis	24		
	For insurance business accounted for on an accident year basis	25		
Claims incurred in reference period (21+22+23-24-25)		26		
Claims incurred for classes 11, 12 or 13 (included in 26)		27		
Claims incurred for "actuarial health insurance" (included in 26)		28		
Sub-total E (26 + ½ 27 - $^2/_3$ 28)		29		
Sub-total F – Conversion of sub-total E to annual figure (multiply by 12 and divide by number of months in the reference period)		31		
Division of sub-total F (gross adjusted claims amount)	x 0.26	32		
	Excess (if any) over ~~35~~37.2M EURO x 0.03	33		
Sub-total G (32 - 33)		39		
Claims amount Sub-total G x **reinsurance ratio** (11.49)		41		
Higher of **premiums amount** and **brought forward amount** (11.53)		42		
General insurance capital requirement (higher of lines 41 and 42)		43		

Instructions for completion of Forms 11 and 12

...

1. For a *composite firm*, Forms 11 and 12 must be completed separately for the total *general insurance business* and for the total *long-term insurance business* which is *class IV*, ~~or~~ supplementary accident and sickness insurance business or *life protection reinsurance business*. For other *firms*, the forms must be completed for the total *general insurance business* or for the total *long-term insurance business* which is *class IV*, ~~or~~ supplementary accident and sickness insurance business or *life protection reinsurance business*, as appropriate.

2. Notwithstanding instruction 1, if the gross annual office premiums for *class IV* business, *life protection reinsurance business* and supplementary accident and sickness insurance in force on the 'valuation date' do not exceed 1% of the gross annual office *premiums* in force on that date for all *long-term insurance business*, Forms 11 and 12 need not be completed for *long-term insurance business* as long as it can be stated that the entry in line 21 of Form 60 exceeds the amount that would be obtained if Forms 11 and 12 were to be completed for *long-term insurance business*. In this circumstance, the method of estimating the entry in line 21 of Form 60, together with a statement of the gross annual office *premiums* in force at the 'valuation date' in respect of *Class IV* business, *life protection reinsurance business* and supplementary accident and sickness insurance, must be given.

3. When completing Forms 11 and 12 for *long-term insurance business* the accounting conventions for *general insurance business* should be followed, but reasonable approximations may be used if they are unlikely to result in an underestimate of the *insurance health risk* and life protection reinsurance *capital component*.

…

10. *Premiums* and *claims* are defined by references to *contracts of insurance* and these themselves are defined by the *Regulated Activities Order* so that *premiums* or *claims* may be included for contracts that would not be treated as insurance under normal accounting conventions. All direct and indirect costs related to the *claims* must be included. For protection *reinsurance* business the discount to the *premium* during any initial period must be ignored, i.e. an adjustment must be made to *premiums* written and *premiums* earned as if the *premium* is the amount excluding the discount and the discount had been accounted for as an expense.

…

Instructions for completion of Form 11

…

2. In accordance with *PRU* 7.2.54R, the reinsurance ratio calculated at line 49 must be:

   - ~~100%~~ 1.00 if sub-total C is zero
   - ~~100%~~ 1.00 if sub-total D / sub-total C exceeds ~~100%~~ 1.00;
   - ~~50%~~ 0.50 if sub-total D / sub-total C is less than ~~50%~~ 0.50; and
   - sub-total D / sub-total C, otherwise.

   The ratio at line 49 must be shown to two decimal places, but the unrounded ratio must be used for calculating **Form 11** line 50 and **Form 12** line 41.

…

Instructions for completion of Form 13

…

11. Lines 60 to 63 and 85 relate only to *general insurance business*. The amount in lines 60-62 recoverable from *Insurance Special Purpose Vehicles* must be disclosed in a supplementary note (code 1320).

…

APPENDIX 9.3 (rules 9.14 and 9.23)

LONG-TERM INSURANCE BUSINESS
REVENUE ACCOUNT AND ADDITIONAL INFORMATION
(FORMS 40 TO 60)

...

Long term insurance capital requirement **Form 60**

Name of insurer
Global business / UK branch business / EEA branch business
Financial year ended
Units

		LTICR factor	Gross reserves / capital at risk	Net reserves / capital at risk	Reinsurance factor	LTICR Financial year	LTICR Previous year
		1	2	3	4	5	6
Insurance death risk capital component							
Life protection reinsurance	11	0.0%					
Classes I (other), II and IX	1~~1~~2	0.1%					
Classes I (other), II and IX	1~~2~~3	0.15%					
Classes I (other), II and IX	1~~3~~4	0.3%					
Classes III, VII and VIII	1~~4~~5	0.3%					
Total	1~~5~~6						
Insurance health risk and life protection reinsurance capital component							
Class IV, ~~and~~ supplementary classes 1 and 2 and life protection reinsurance	21						
Insurance expense risk capital component							
Life protection and permanent health reinsurance	31	0%					
Classes I (other), II and IX	3~~1~~2	1%					
Classes III, VII and VIII (investment risk)	3~~2~~3	1%					
Classes III, VII and VIII (expenses fixed 5 yrs +)	3~~3~~4	1%					
Classes III, VII and VIII (other)	3~~4~~5	25%					
Class IV (other)	3~~5~~6	1%					
Class V	3~~6~~7	1%					
Class VI	3~~7~~8	1%					
Total	3~~8~~9						
Insurance market risk capital component							
Life protection and permanent health reinsurance	41	0%					
Classes I (other), II and IX	4~~1~~2	3%					
Classes III, VII and VIII (investment risk)	4~~2~~3	3%					
Classes III, VII and VIII (expenses fixed 5 yrs +)	4~~3~~4	0%					
Classes III, VII and VIII (other)	4~~4~~5	0%					
Class IV (other)	4~~5~~6	3%					
Class V	4~~6~~7	0%					
Class VI	4~~7~~8	3%					
Total	4~~8~~9						
Long term insurance capital requirement	51						

…

Instructions for completion of Form 60

1. The *insurance death risk capital component* in lines 11-15 column 5 is based on capital at risk for those contracts where it is not negative. Capital at risk is the benefit payable as a result of death less the *mathematical reserves* after distribution of surplus. *Life protection reinsurance business* written by a *pure reinsurer* or a *mixed insurer* is reported in line 11. Other b~~B~~usiness in classes I, II and IX must be split between lines 1~~1~~2, 1~~2~~3 and 1~~3~~4 in accordance with *PRU* 7.2.82R. Line 1~~1~~2 is for temporary insurance on death where the original term of the contract is 3 years or less or for a *pure reinsurer*. Line 1~~2~~3 is for temporary insurance where the original term is 5 years or less but more than 3 years. Line 1~~3~~4 is for other *class* I, II or IX business. For a *pure reinsurer* the factor of 0.3% in column 1 of line 1~~4~~5 must be replaced by 0.1%.

2. In lines 11-1~~4~~5 columns 2 and 3 are the gross and net capital at risk in accordance with *PRU* 7.2.83R. For lines 1~~1~~2-1~~3~~4 the reinsurance factor is calculated in aggregate, so column 4 is the sum of lines 1~~1~~2-1~~3~~4 column 3 divided by the sum of lines 1~~1~~2-1~~3~~4 column 2, subject to a minimum of 0.5 in accordance with *PRU* 7.2.81R. For line 1~~4~~5 column 4 is column 3 divided by column 2, subject to a minimum of 0.5 in accordance with *PRU* 7.2.81R. Column 5 is column 1 x column 2 x column 4.

3. The *insurance health risk and life protection reinsurance capital component* in line 21 column 5 must be equal to the entry at line 43 in Form 12 for *long-term insurance business*, subject to instruction 2 to Forms 11 and 12.

4. For the purpose of calculating the *insurance expense risk capital component* and the *insurance market risk capital component* linked contracts must be allocated to:
   - lines 3~~2~~3 and 4~~2~~3 where the *firm* bears an investment risk,
   - lines 3~~3~~4 and 4~~3~~4 where the *firm* does not bear an investment risk but where the allocation to cover *management expenses* is fixed for a period exceeding 5 years from the commencement of the contract, and
   - lines 3~~4~~5 and 4~~4~~5, otherwise.

   Life protection reinsurance business and *permanent health reinsurance business* written by a *pure reinsurer* or a *mixed insurer* must be allocated to lines 31 and 41.

5. The *insurance expense risk capital component* for linked contracts where the *firm* bears no investment risk and the allocation to cover *management expenses* does not have a fixed upper limit for a period exceeding 5 years from the commencement of the contract in line 3~~4~~5 is 25% of net *administrative expenses* in accordance with *PRU* 7.2.88R(1).

6. The *insurance expense risk capital component* for *class V* in line 3~~6~~7 column 5 is 1% of the assets of the tontine in accordance with *PRU* 7.2.88R(2).

7. The *insurance expense risk capital component* for other business in lines 3~~1~~2, 3~~2~~3, 3~~3~~4, 3~~5~~6 and 3~~7~~8 column 5 is 1% of adjusted *mathematical reserves* after distribution of surplus in accordance with *PRU* 7.2.88R(3). Column 4 is column 3 divided by column 2, subject to a minimum of 85% (50% for a pure reinsurer) in accordance with *PRU* 7.2.90R. Column 5 is column 1 x column 2 x column 4.

8. The *insurance market risk capital component* in lines 4~~3~~4 and 4~~4~~5 column 5 for class III, VII and VIII contracts where the *firm* does not bear any investment risk and in line 4~~5~~6 for class V contracts is nil in accordance with *PRU* 7.2.89R.

9. The *insurance market risk capital component* in line 4~~1~~2, 4~~2~~3, 4~~5~~6 and 4~~7~~8 column 5 is 3% of adjusted *mathematical reserves* after distribution of surplus in accordance with *PRU* 7.2.89R. Column 4 is column 3 divided by column 2 subject to a minimum of 85% (50% for a pure reinsurer) in accordance with *PRU* 7.2.90R. Column 5 is column 1 x column 2 x column 4. The amount in line 49 column 3 must equal the amount in Form 14 line 11.

10. The *long term insurance capital requirement* in line 51 column 5 is the sum of column 5 in lines 1~~5~~6, 21, 3~~8~~9 and 4~~8~~9.

Annex G

Amendments to the Supervision manual

In this Annex underlining indicates new text.

…

3.1.2 R Table: Applicable sections (see SUP 3.1.1R)

(1) Category of firm	(2) Sections applicable to the firm	(3) Sections applicable to its auditor
…		
(6) *Insurer*, the *Society of Lloyd's, underwriting agent* or *members' adviser, ISPV* (Note 5)	SUP 3.1-SUP 3.7	SUP 3.1, SUP 3.2, SUP 3.8
…		

…

16.7.5 G Table: Applicable rules and guidance on reports (see SUP 16.7.1G)

Firm category	Applicable rules and guidance
…	
Service company	SUP 16.7.20R – SUP 16.7.21R
ISPV	SUP 16.7.21AR – SUP 16.7.21BR
…	

…

Insert after SUP 16.7.21R

Insurance Special Purpose Vehicles

16.7.21A R An *ISPV* must submit reports to the *FSA* in accordance with SUP 16.7.21BR.

16.7.21B R Table: Financial reports required from Insurance Special Purpose Vehicles

Report	Frequency	Due date
Annual audited financial statements	Annually	3 months after the *firm's accounting reference date*

…

PUB REF: 2591

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