

Chapter 21

Permitted Links and conditional permitted links



21.1 Application

21.1.1 **R** The *rules* in this section apply on an ongoing basis to *insurers* who effect *linked long-term* contracts.

Limit to the application of COBS 21.3

21.1.1A **R** ■ COBS 21.3 (Further rules for firms engaged in linked long-term insurance business) applies only in respect of *linked long-term contracts of insurance* where the investment risk is borne by a *policyholder* who is a natural person.

21.1.2 **R**



21.2 Rules for firms engaged in linked long-term insurance business

21.2.1 **R** For the purposes of determining *policyholder* benefits, a *firm* must ensure that the values of its *permitted links* and *conditional permitted links* are determined fairly and accurately.

21.2.1A **R** An *insurer* must not contract to provide benefits under *linked long-term contracts of insurance* that are determined wholly or partly, directly or indirectly, by reference to fluctuations in any index or wholly or partly by reference to the value of, or the income from, or fluctuations in the value of, property other than in accordance with the rules in this section.

21.2.1B **G** *Insurers* effecting *linked long-term contracts of insurance* are obliged to comply with the requirements on investments in the PRA Rulebook Solvency II Firms Investments.

21.2.2 **R**

21.2.3 **R**

21.2.4 **R** A *firm* must notify its *linked policyholders* of the risk profile and investment strategy for the *linked fund*:

- (1) at *inception*;
- (2) before making any material changes; and
- (3) (in relation to *conditional permitted links*) at other appropriate times, taking into account a *policyholder's* needs.

Reinsurance

21.2.4A **R** A *firm* that has entered into a *reinsurance contract* in respect of its linked long-term insurance business must nevertheless discharge its responsibilities under its *linked long-term insurance contracts*, as if no *reinsurance contract* had been effected.

- 21.2.4B **G** To comply with the requirements of **■ COBS 21.2.4A R**, a *firm* should:
 - (1) disclose to *policyholders* the implications of any credit-risk exposure they may face in relation to the solvency of the reinsurer; and
 - (2) suitably monitor the way the reinsurer manages the business in order to discharge its continuing responsibilities to *policyholders*.

21.2.5 **R**

21.2.6 **R**

21.2.7 **R**

Notification to the FCA

21.2.8 **R** A *firm* must notify the *FCA* in writing as soon as it becomes aware of any failure to meet the requirements of **■ COBS 21**, or of the PRA Rulebook Solvency II Firms Investments or the PRA Rulebook: Non-Solvency II firm sector to the extent applicable to *linked long-term contracts of insurance*.

21.2.9 **G** In considering what action to take in response to written notification of a failure to meet the requirements of this section, the *FCA* will have regard to the extent to which the relevant circumstances are exceptional and temporary and to any other reasons for the failure.

21.3 Further rules for firms engaged in linked long-term insurance business

Application

21.3.-1 **R** The rules in this section apply to *linked long-term contracts of insurance* where the investment risk is borne by a *policyholder* who is a natural person.

Permitted links and conditional permitted links

21.3.1 **R** An *insurer* must not contract to provide benefits under *linked long-term contracts of insurance* that are determined:

- (1) wholly or partly, or directly or indirectly, by reference to fluctuations in any index other than an *approved index*;
- (2) wholly or partly by reference to the value of, or the income from, or fluctuations in the value of, property other than any of the following:
 - (a) *approved securities*;
 - (b) *listed securities*;
 - (c) *permitted unlisted securities*;
 - (d) *permitted land and property*;
 - (e) *permitted loans*;
 - (f) *permitted deposits*;
 - (g) *permitted scheme interests*;
 - (h) *approved money market instruments* meeting the requirements in ■ COBS 21.3.6 R to ■ COBS 21.3.8 G;
 - (i) *cash*;
 - (j) *permitted units*;
 - (k) *permitted stock lending*;
 - (l) *permitted derivatives contracts*; and
 - (m) *conditional permitted links*.

21.3.1A **R** A *firm* must classify the types of property listed in ■ COBS 21.3.1R (2)(a) to ■ (2)(m) according to their economic behaviour ahead of their legal form.

- 21.3.2 G
 - (1) Nothing in these rules prevents a *firm* making allowance in the value of any *permitted link* or *conditional permitted link* for any notional tax loss associated with the relevant *linked assets* for the purposes of fair pricing.
 - (2) In the *FCA's* view the Consumer Prices Index, as well as the Retail Prices Index, is a national index of retail prices and so may be used as an *approved index* for the purposes of ■ COBS 21.3.1R (1).

21.3.3 R

21.3.4 G

21.3.5 R

Money-market instruments

21.3.6 R A *money-market instrument* will be regarded as normally dealt in on the money market if it:

- (1) has a maturity at issuance of up to, and including, 397 *days*; or
- (2) has a residual maturity of up to, and including, 397 *days*; or
- (3) undergoes regular yield adjustments in line with money market conditions at least every 397 *days*; or
- (4) undergoes regular yield adjustments in line with money market conditions at least every 397 *days*.

21.3.7 R

- (1) A *money-market instrument* will be regarded as liquid if it can be sold at limited cost in an adequately short timeframe.
- (2) A *money-market instrument* will be regarded as having a value which can be accurately determined at any time if accurate and reliable valuations systems, which fulfil the following criteria, are available:
 - (a) enabling the *firm* to calculate a net asset value in accordance with the value at which the instrument held in the portfolio could be exchanged between knowledgeable willing parties in an arm's length transaction; and
 - (b) based either on market data or on valuation models, including systems based on amortised costs.
- (3) A *money-market instrument* that is normally dealt in on the money market and is admitted to, or dealt in, on an *eligible* market will be presumed to be liquid and have a value which can be accurately determined at any time, unless there is information available to the *firm* that would lead to a different determination.

21.3.8 **G** A firm should assess the liquidity of a *money-market instrument* in accordance with *CESR's UCITS eligible assets guidelines*, with respect to UK provisions which implemented article 4(1) of the *UCITS eligible assets Directive*.

Permitted stock lending transactions

21.3.9 **R** A *permitted stock lending* transaction is one which, for a *Solvency II firm*, satisfies the requirements in ■ COBS 21.3.11 R to ■ COBS 21.3.12 R and, for an *insurer* which is not a *Solvency II firm*, satisfies ■ INSPRU 3.2.36A R to ■ INSPRU 3.2.42 G.

21.3.10 **R** The specific method of *stock lending* permitted is an arrangement of the kind described in section 263B of the Taxation of Chargeable Gains Act 1992, under which the lender transfers *securities* to the borrower other than by way of *sale* and the borrower is to transfer those *securities*, or *securities* of the same type and amount, back to the lender at a later date. In accordance with good market practice, a separate transaction by way of transfer of assets is also involved for the purpose of providing *collateral* to the "lender" to cover him against the risk that the future transfer back of the *securities* may not be satisfactorily completed.

Stock lending: requirements

21.3.11 **R**

- (1) The *stock lending* arrangement is of the kind described in section 263B of the Taxation of Chargeable Gains Act 1992 (without extension by section 263C), and:
 - (a) all the terms of the agreement under which *securities* are to be reacquired by the *firm* for the account of the unit-linked fund are in a form which is acceptable to the *firm* and in accordance with good market practice;
 - (b) the counterparty is:
 - (i) an *authorised person*; or
 - (ii) a *person* authorised in an *EEA State*; or
 - (iii) a *person* registered as a broker-dealer with the Securities and Exchange Commission of the United States of America; or
 - (iv) a bank, or a branch of a bank, supervised and authorised to deal in investments as principal, with respect to *OTC derivatives*, by at least one of the following federal banking supervisory authorities of the United States of America:
 - (A) [deleted];
 - (B) the Federal Deposit Insurance Corporation;
 - (C) the Board of Governors of the Federal Reserve System; and
 - (D) the Office of Thrift Supervision; and
 - (c) *collateral* is obtained to secure the obligation of the counterparty under the terms in (a) and the *collateral* is:
 - (i) acceptable to the *firm*;
 - (ii) adequate; and

- (iii) sufficiently immediate; and
- (d) for the purposes of *property-linked assets* only:
 - (i) where the *linked policyholder* bears the whole of the risk associated with the *stock lending* transaction, the *linked policyholder* receives the whole of the recompense (net of fees and expenses);
 - (ii) the extent of any risk that the *linked policyholder* bears in relation to the *stock lending* transaction is disclosed to them; and
 - (iii) where the risk associated with the *stock lending* transaction is borne outside the *linked fund*, the linked fund receives a fair and reasonable recompense for the use of the *linked policyholders'* funds.
- (2) The counterparty for the purpose of (1) is the *person* who is obliged under the agreement in (1)(a) to transfer to the *firm* the *securities* transferred by the *firm* under the *stock lending* arrangement or *securities* of the same kind.
- (3) ■ COBS 21.3.11R (1)(c) does not apply to a *stock lending* transaction made through Euroclear Bank SA/NV's Securities Lending and Borrowing Programme.

Stock lending: treatment of collateral

21.3.12

R

- (1) *Collateral* is adequate for the purposes of this section only if it is:
 - (a) transferred to the *firm* or the *firm's* agent;
 - (b) at least equal in value, at the time of the transfer to the *firm* or its agent, to the value of the *securities* transferred by the *firm*; and
 - (c) in the form of one or more of:
 - (i) cash;
 - (ii) a certificate of *deposit*;
 - (iii) a letter of *credit*;
 - (iv) a *readily realisable security*;
 - (v) commercial paper with no embedded *derivative* content;
 - (vi) a *qualifying money market fund*.
- (2) *Collateral* is sufficiently immediate for the purposes of this section if:
 - (a) it is transferred before or at the time of the transfer of the *securities* by the *firm*; or
 - (b) the *firm* takes reasonable care to determine at the time referred to in (a) that it will be transferred at the latest by the close of business on the *day* of the transfer.
- (3) The *firm* must ensure that the value of the collateral at all times is at least equal to the value of the *securities* transferred by the *firm*.
- (4) The duty in (3) may be regarded as satisfied in respect of *collateral* the validity of which is about to expire, or has expired, where the *firm* takes reasonable care to determine that sufficient *collateral* will

be transferred, at the latest, by the close of business on the *day* of expiry.

Permitted derivatives contracts

21.3.13 **R** A *permitted derivatives contract* is one which:

- (1) for a *Solvency II firm*, is effected or issued:
 - (a) on or under the rules of a *regulated market*; or
 - (b) off-market with an *approved counterparty*; and
 satisfies ■ COBS 21.3.14 G; and
- (2) for an *insurer* which is not a *Solvency II firm*, satisfies ■ INSPRU 3.2.5 R to ■ INSPRU 3.2.35A G with the exception of ■ INSPRU 3.2.18 R; and
- (3) in each of (1) and (2) the provisions are applied in relation to assets covering liabilities in respect of *linked long-term* contracts of insurance.

21.3.14 **G** *Solvency II firms* are also required to comply with the PRA Rulebook Solvency II Firms Investment and ensure that the use of *derivative* contracts is adequately covered. *Firms* are also referred to the *rules* in ■ COLL 5.3 (Derivative Exposure) in relation to the use of *derivatives* in investment funds and the further guidance from CESR and its successor body, ESMA, which represent good practice in this area.

Conditional permitted links

21.3.15 **R** A *conditional permitted link* is any of the following property where the conditions in ■ COBS 21.3.16R are met:

- (1) *conditional permitted unlisted securities*;
- (2) *conditional permitted immovables*;
- (3) *conditional permitted loans*; and
- (4) *conditional permitted scheme interests*.

21.3.16 **R** The conditions for the property in ■ COBS 21.3.15R to be a *conditional permitted link* are that an *insurer* must ensure, on a continuing basis, that:

- (1) a *linked policyholder* is not prevented by the nature of any *conditional permitted link* from exercising any right under the *linked long-term contract of insurance* within the timeframe specified in that contract and, in any event;
 - (a) (in relation to rights to take benefits due under the contract) within a reasonable timeframe based on the needs of the *linked policyholder*; and
 - (b) (in relation to other rights under the contract) within a timeframe that may be reasonably necessary to allow the *firm* to

manage the *linked fund* prudently and in the best interests of all relevant *policyholders* linked to the fund.

- (2) the investment risks of any *conditional permitted links*, both individually and in combination with other investments within a linked fund, are suitable and appropriate for:
 - (a) circumstances where investment risk is borne by a *linked policyholder*;
 - (b) the expected period to maturity of the *linked long-term contract of insurance*; and
 - (c) the purpose for which the *linked policyholder* holds the *linked long-term contract of insurance*.

21.3.17 G

- (1) Rights under a *linked long-term contract of insurance* which may be relevant for the purposes of ■ COBS 21.3.16R(1) would include a *linked policyholder's* right to:
 - change the property to which the benefits of the *linked long-term contract of insurance* are linked;
 - take benefits due under the *linked long-term contract of insurance*. Benefits due are those which the contract envisages will be paid at a particular date or on the occurrence of a particular event; or
 - withdraw early or transfer the proceeds of, or benefits under, the *linked long-term contract of insurance*. Early withdrawal refers to withdrawals prior to the time or event for paying benefits due that is specifically envisaged in the contract.
- (2) A *firm* will have to pay benefits due under a *linked long-term contract of insurance* (for example on death or maturity) as specified in the contract. A *firm* is not permitted to specify in the contract that it can defer the payment of any such benefits as, in any event, benefit payments have to be made within a reasonable period based on the needs of the *policyholder*.
- (3) A *linked long-term contract of insurance* may provide that the *policyholder's* right to exercise rights under (1)(a) or (1)(c) is deferred for as long as may be reasonably necessary to allow the *firm* to ensure that a *linked fund* can be managed in a manner that is prudent and in the best interests of all relevant *policyholders* linked to the fund. The *firm* will need to ensure that it explains clearly to a *policyholder* the impact of any such provision on the *policyholder's* rights to withdraw early, switch or transfer.

21.3.18 G

The assessment in ■ COBS 21.3.16R(2), in relation to a *linked fund* which is included in a default or similar arrangement for a pension scheme, would include ongoing consideration of whether the investment risks of any *conditional permitted links* remain suitable and appropriate for a particular cohort of *linked policyholders*, including as that cohort moves toward retirement.

Conditional permitted links: requirements

21.3.19 **R** Where a *linked fund* is invested in any *conditional permitted link*, no more than 35% of the gross assets of the *linked fund*, when aggregated together, can be invested in:

- (1) *permitted scheme interests* in (b)(v) of the *Glossary* definition of that term; and
- (2) *conditional permitted links*.

21.3.20 **R** Where a *linked fund* is invested in any *conditional permitted link*, the information that a *firm* must give a *linked policyholder* under **COBS 21.2.4R** must also prominently include, clearly and in language capable of being understood by a *linked policyholder*:

- (1) an explanation of the risks associated with any *conditional permitted links* and/or gross assets in *permitted scheme interests* exceeding 20%, how these might crystallise and how they might impact on a *linked policyholder*;
- (2) a description of the tools and arrangements which the *insurer* would propose using, including those required by *FCA rules*, to mitigate the risks in (1);
- (3) an explanation of the circumstances in which these tools and arrangements would typically be deployed and the likely consequences for *linked policyholders*; and
- (4) an explanation of the possible impact on the *policyholder* of any provision in a *linked long-term contract of insurance* permitted under this section which allows for the deferral of the exercise of any rights under the contract.

