

## Chapter 21

# Permitted Links and conditional permitted links

## 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

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- (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*;
- (4) *conditional permitted scheme interests*;
- (5) *conditional permitted long-term asset funds*; and
- (6) (only in respect of a *linked fund* included in the *default arrangement* of a *qualifying scheme*) *conditional permitted illiquid assets*.

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) (only in respect of *conditional permitted long-term asset funds* to be held other than in connection with a *qualifying scheme*) the *policyholder* has received:
  - a *personal recommendation*, or investment management services, from a *firm*, as to the suitability of the investment for the *policyholder*; or

- (b) (where the *policyholder* has not received any of the services in (a)) an assessment from a *firm* (which could be the *insurer*, and where the circumstances are appropriate, the *firm* may rely on assessments made by another *person* on whom it is reasonable for the *firm* to rely) that the investment is appropriate for the *policyholder* in accordance with ■ COBS 21.3.16AR;
- (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*.
- (3) (only in respect of *conditional permitted illiquid assets*) the *linked fund* investing in *conditional permitted illiquid assets* may only be included in the *default arrangements* of a *qualifying scheme*.

**21.3.16A R**

- (1) The appropriateness assessment in ■ COBS 21.3.16R(-1)(b) must be done in accordance with the *rules* in either ■ COBS 10 or ■ COBS 10A.
- (2) The effect of (1) is that if the *rules* in ■ COBS 10 or ■ COBS 10A do not apply to a *firm*, the assessment the *policyholder* has received must be undertaken by the *firm* as if the *rules* in ■ COBS 10 or ■ COBS 10A applied.
- (3) Where (2) applies, the condition in ■ COBS 21.3.16R(-1)(b) will be met where a *firm* has conducted the appropriateness assessment in accordance with either:
  - (a) ■ COBS 10 as it would apply to a *firm* that *arranges or deals* in relation to a *unit* in a *long-term asset fund*; or
  - (b) ■ COBS 10A as it would apply to a *firm* that either:
    - (i) provides *investment services* in relation to a *unit* in a *long-term asset fund*; or
    - (ii) carries on *insurance distribution* in relation to an *insurance-based investment product* (taking into account the guidance



in ■ COBS 10A 2.12G as if it referred to investment in *conditional permitted long-term asset funds*), and

the *firm* must apply the set of *rules* in either (a), (b)(i) or (b)(ii) which are the most:

- (c) consistent with the *firm's* understanding and experience; and
- (d) appropriate for the *policyholder*.

- (4) The appropriateness assessment must ensure (but is not limited to ensuring) that the total exposure the *policyholder* has or would have to *conditional permitted long-term asset funds*, at the point the investment is made and based on expected contributions at the time, is not greater than 10% of:
  - (a) (in relation to a *policy* held by an individual *policyholder* who is a natural person) the person's exposure to *permitted links* in the *policy*;
  - (b) (other than in (a) and (c) and where the investment risk is borne by a *policyholder* who is a natural person) that natural person's individual exposure to *permitted links* in the *policy*; or
  - (c) (where the *policy* is used by the holder of the *policy* for the purposes of providing benefits under a pension scheme, other than a *qualifying scheme*, and the investment risk is borne by a member of the scheme who is a *policyholder* and a natural person), the value of that natural person's benefits under the pension scheme.

**21.3.16B** G

- (1) Where a *firm* carries out insurance distribution in relation to an *insurance-based investment product* that includes investment in a *conditional permitted long-term asset fund*, the appropriateness requirement in ■ COBS 10A will apply to that *firm* in any event. Therefore, ■ COBS 21.3.16AR(2) will not be relevant to that activity.
- (2) Where the rules in ■ COBS 10 or ■ COBS 10A do not apply, the *firm* undertaking the appropriateness assessment will have the option of electing which *rules* would be most appropriate to follow. The purpose of this is to allow for *firms* to carry out the appropriateness assessment under the *rules* with which they may be most familiar for example where they are involved with the distribution of *units* in *long-term asset fund* or where the *firm* already has processes in place to meet ■ COBS 10A in relation to *insurance-based investment products*. However, this flexibility will need to be exercised in a way that maintains adequate protection for *policyholders* wanting to invest in *conditional permitted long-term asset funds*.
- (3) Where a *firm* is subject to the *rules* in ■ COBS 10A when providing *investment services* in relation to *units* in a *long-term asset fund* it should not elect to comply with the *rules* in ■ COBS 21.3.16AR(3)(a) or ■ (b)(ii) unless it can demonstrate why applying those *rules* was appropriate for the *policyholder*.
- (4) Where the *policy* is used for the purposes of a pension arrangement (for example an *occupational pension scheme* where the trustees include investment in a *long-term contract of insurance*) under which there is more than one *policyholder*, the assessment in ■ COBS 21.3.16AR(4)(c), should consider the total individual exposure



that any relevant *policyholder* (who is a natural person and bears the investment risk) has to *conditional permitted long-term asset funds* in that pension scheme, compared to the total value of the benefits that person has under their individual arrangement in the pension scheme.

- 21.3.16C** G For ■ **COBS 21.3.16R(-1)(b)** it would be reasonable for an *insurer* to rely on assessments carried out by a *person* who is not a *firm* where:
- (1) this is properly done by or for an *occupational pension scheme* trustee or otherwise where the person has a legal responsibility to the *policyholder* who is a natural person to assess appropriateness;
  - (2) the *insurer* has the necessary systems and controls to determine how the assessment assists the *insurer* to comply with ■ **COBS 21.3.16AR**; and
  - (3) where there is not another *firm* that has (or could) carry out an appropriateness assessment that the *firm* is able to rely on.
- 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:

- (1) 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; and
- (2) where the *linked fund* contains *conditional permitted long-term asset funds* or *conditional permitted illiquid assets*, the total exposure of the *default arrangement* to those *investments*.

**R** The assessment in ■ COBS 21.3.16R(2), in relation to a *linked fund* which is included in an individual pension arrangement under a *qualifying scheme* in circumstances where the member self-selects the *linked assets*, must include ensuring that the total exposure of that individual pension arrangement to *conditional permitted long-term asset funds* is not greater than the higher of:

- (1) the exposure to *conditional permitted long-term asset funds* and/or *conditional permitted illiquid assets* which would be considered suitable and appropriate if that member were invested only in the *qualifying scheme's default arrangement*; or
- (2) 10% of the total value of the benefits in that individual pension arrangement under the *qualifying scheme*.

- G**
- (1) The assessment of the thresholds in ■ COBS 21.3.16AR(4) and ■ COBS 21.3.18AR should consider whether these are or would be exceeded at the point of the proposed investment being made (including the effect of any ongoing contributions as part of that investment).
  - (2) Before the *policyholder* makes any further investment in *conditional permitted long-term asset funds* there will need to be an assessment of whether the conditions in ■ COBS 21.3.16R, including the thresholds in ■ COBS 21.3.16AR(4) and ■ COBS 21.3.18AR, will continue to be met (including in relation to ongoing monthly contributions where the thresholds could be breached).
  - (3) An *insurer* should consider how to meet the obligation in ■ COBS 21.3.16R for the conditions to be met on a 'continuing basis' and also its obligations under wider *rules* including the *Principles*. Whilst the condition in ■ COBS 21.3.16R(-1) would apply at the point the particular investment is being made including taking account of any ongoing contributions as part of that investment (rather than on a continuing basis), the *insurer* should have appropriate arrangements in place to identify whether a *policyholder's* investment exposure has become, or risks becoming, materially inconsistent with the thresholds in ■ COBS 21.3.16AR(4) or ■ COBS 21.3.18AR. Where this has occurred the *insurer* should take appropriate action for example communicating with the *policyholder* about this risk and their options.

### 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*.

**21.3.19A** **R** The gross assets that a *linked fund* invests in *conditional permitted long-term asset funds* (when included in a *qualifying scheme*) or *conditional permitted illiquid assets* (when included in the *default arrangement* of a *qualifying scheme*) must not be included in any part of the calculation when working out whether the limit set out in **COBS 21.3.19R** has been exceeded.

**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* in (b)(v) of the *Glossary* definition of that term 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.