

## 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

**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

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- (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

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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.