

# Prudential Sourcebook for Insurers

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# Chapter 1

## Capital resources requirements and technical provisions for insurance business

1.1

Application

- 1.1.1
- R
- INSPRU 1.1 applies to an *insurer* unless it is:

  - (1) a *non-directive friendly society*; or
  - (2) [deleted]
  - (3) [deleted]
  - (4) a *Solvency II firm*.
- 1.1.2
- R
- (1) This section applies to a *firm* in relation to the whole of its business, except where a particular provision provides for a narrower scope.
  - (2) Where a *firm* carries on both *long-term insurance business* and *general insurance business*, this section applies separately to each type of business.
- 1.1.3
- R
- For an *insurer* with a *branch* in the *United Kingdom* whose *insurance business* in the *United Kingdom* is not restricted to *reinsurance* other than a *Swiss general insurer* ■ INSPRU 1.1.27R applies separately in respect of its world-wide activities and its activities carried on from a *branch* in the *United Kingdom*.

1.1.4 **R** [deleted]

1.1.5 **R** [deleted]

1.1.6 **G** [deleted]

## Assets of a value sufficient to cover technical provisions and other liabilities

1.1.27 **R** A firm carrying on *long-term insurance business* must ensure that it has *admissible assets* in each of its *with-profits funds* of a value sufficient to cover:

- (1) the *technical provisions* in respect of all the business written in that *with-profits fund*; and
- (2) its other *long-term insurance liabilities* in respect of that *with-profits fund*.

1.1.28 **R**

1.1.29 **G** [deleted]

1.1.53 **G** [deleted]

1.1.74 **G** [deleted]

1.1.75 **G** [deleted]

1.2 Mathematical reserves

Application

- 1.2.1 R
- INSPRU 1.2 applies to a *long-term insurer* unless it is:
- (1) a *non-directive friendly society*; or

(2) [deleted]

(3) [deleted]

(4) a *Solvency II firm*.

Purpose

- 1.2.6 G
- A number of the *rules* in this section require a *firm* to take into account its regulatory duty to treat *customers* fairly. In this section, references to such a duty are to the duty of a *firm* regulated by the *FCA* to pay due regard to the interests of its *customers* and to treat them fairly (see the *FCA's Principle 6* in *PRIN*). This duty is owed to both *policyholders* and potential *policyholders*.
- 1.2.6A G
- Some of the rules made by the *FCA* contain references to, or are reliant on, *rules* that are only made by the *PRA*. *Firms* should consider ■ GEN 2.2.13A R (cross-references in the *Handbook*) and ■ GEN 2.2.23 R to ■ GEN 2.2.25 G (cutover: application of provisions made by both the *FCA* and the *PRA*) when applying these *rules*. In the context of mathematical reserves, the *FCA rules* ensure a *firm* takes into account its regulatory duty to treat *customers* fairly.

Methods and assumptions

- 1.2.10 R
- In the actuarial valuation under *PRA Rulebook: Non Solvency II firms: Insurance Company – Mathematical Reserves, 2.1*, a *firm* must use methods and prudent assumptions which:
- (1) are appropriate to the business of the *firm*;

(2) are consistent from year to year without arbitrary changes (see ■ INSPRU 1.2.11 G);

(3) are consistent with the method of valuing assets (see *PRA Rulebook: Non-Solvency II firms: Insurance Company – Overall Resources and Valuation, 3*);

(4) include appropriate margins for adverse deviation of relevant factors;



- (5) recognise the distribution of profits (that is, emerging surplus) in an appropriate way over the duration of each *contract of insurance*;
- (6) take into account its regulatory duty to treat its *customers* fairly (see *FCA's Principle 6*); and
- (7) are in accordance with generally accepted actuarial practice.

**1.2.11** G ■ **INSPRU 1.2.10R (2)** prohibits only arbitrary changes in methods and assumptions, that is, changes made without adequate reasons. Any such changes would hinder comparisons over time as to the amount of the *mathematical reserves* and so obscure trends in solvency and the emergence of surplus.

### Record keeping

**1.2.20** R A *firm* must make, and retain for an appropriate period, a record of:

- (1) the methods and assumptions used in establishing its *mathematical reserves*, including the margins for adverse deviation, and the reasons for their use; and
- (2) the nature of, reasons for, and effect of, any change in approach, including the amount by which the change in approach increases or decreases its *mathematical reserves*.

**1.2.21** G For the purposes of ■ **INSPRU 1.2.20 R**, records should be maintained for a period of longer than three years for a *firm's long-term insurance business*. In determining an appropriate period, a *firm* should have regard to:

- (1) [deleted]
- (2) the nature and term of the *firm's* long-term insurance business; and
- (3) any additional provisions or statutory requirements applicable to the *firm* or its records.

### Cash flows to be valued

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

- (1) include in the cash flows to be valued the following:
  - (a) future *premiums*;
  - (b) expenses, including *commissions*;
  - (c) benefits payable (see ■ **INSPRU 1.2.29 R**); and
  - (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; 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 1.2.28 R under sections 138A and 138B of the Act.
- 1.2.29** **R** For the purpose of ■ INSPRU 1.2.28R (1)(c), benefits payable include:
- (1) all guaranteed benefits including guaranteed *surrender values* and paid-up values;
  - (2) vested, declared and allotted bonuses to which the *policyholder* is entitled;
  - (3) all options available to the *policyholder* under the terms of the contract; and
  - (4) discretionary benefits payable in accordance with the *firm's* regulatory duty to treat its *customers* fairly.
- 1.2.30** **G** All cash flows are to be valued using prudent assumptions in accordance with generally accepted actuarial practice. Cash flows may be omitted from the valuation calculations provided the reserves obtained as a result of leaving those cash flows out of the calculation are not less than would have resulted had all cash flows been included. Provision for future expenses in respect of *with-profits insurance contracts* (excluding *accumulating with-profits policies*) may be made implicitly, using the *net premium* method of valuation. For the purposes of ■ INSPRU 1.2.28R (1)(b), any charges included in expenses should be determined in accordance with the *firm's* regulatory duty to treat its *customers* fairly.
- 1.2.31** **G** ■ INSPRU 1.2.29R (4) requires *firms* to make allowance for any future *annual bonus* that a *firm* would expect to grant, assuming future experience is in line with the assumptions used in the calculation of the *mathematical reserves*. *Final bonuses* do not have to be taken into consideration in these calculations except in relation to *accumulating with-profits policies*. The calculations required for *accumulating with-profits policies* are set out in ■ INSPRU 1.2.71R (1).
- Mortality and Morbidity**.....
- 1.2.59** **R** A *firm* must set the assumptions for mortality and morbidity using prudent rates of mortality and morbidity that are appropriate to the country or territory of residence of the person whose life or health is insured.
- 1.2.60** **G** The rates of mortality or morbidity should contain prudent margins for adverse deviation. In setting those rates, a *firm* should take account of:

- (1) the systems and controls applied in underwriting *long-term insurance contracts* and whether they provide adequate protection against anti-selection (that is, selection against the *firm*) including:
  - (a) adequately defining and identifying non-standard risks; and
  - (b) where such risks are underwritten, allocating to them an appropriate weighting;
- (2) the nature of the contractual exposure to mortality or morbidity risk including:
  - (a) whether lower mortality increases or decreases the *firm's* liability;
  - (b) the period of cover and whether risk charges can be varied during that period and, if so, how quickly; and
  - (c) whether the options in the contract give rise to a significant risk of anti-selection (for example, opportunities for voluntary discontinuance, guaranteed renewal at the option of the *policyholder* and rights for conversion of benefits);
- (3) the credibility of the *firm's* actual experience as a basis for projecting future experience including:
  - (a) whether there is sufficient data (especially for medical or financial risks and for new types of benefit or new methods of distribution); and
  - (b) whether the data is reliable and has been appropriately validated;
- (4) the availability and reliability of:
  - (a) any published tables of mortality or morbidity for the country or territory of residence of the person whose life or health is insured; and
  - (b) any other information as to the industry-wide insurance experience for that country or territory;
- (5) anticipated or possible future trends in experience including, but only where they increase the liability:
  - (a) anticipated improvements in mortality;
  - (b) changes arising from improved detection of morbidity (including critical illnesses);
  - (c) diseases the impact of which may not yet be reflected fully in current experience; and
  - (d) changes in market segmentation (such as impaired life annuities) which, in the light of developing experience, may require different assumptions for different parts of the policy class.

**1.2.61**

**G**

An additional provision for diseases covered by ■ [INSPRU 1.2.60G \(5\)\(c\)](#) may be needed, in particular for unit-linked policies. In determining whether such a provision is needed a *firm* may take into consideration any ability to increase product charges commensurately (provided that such increase does not infringe on its regulatory duty to treat its *customers* fairly), but a provision would still be required for the period until such an increase could be brought into effect.

## Options

- 1.2.62** **R** When a *firm* establishes its *mathematical reserves* in respect of a *long-term insurance contract*, the *firm* must include an amount to cover any increase in liabilities which might be the direct result of its *policyholder* exercising an option under, or by virtue of, that *contract of insurance*. Where the *surrender value* of a contract is guaranteed, the amount of the *mathematical reserves* for that contract at any time must be at least as great as the value guaranteed at that time.
- 1.2.62A** **G** A contract has a guaranteed *surrender value* where the *policy* wording states that a *surrender value* is payable and either provides for a minimum amount payable on surrender or sets out a method for calculating such an amount. For example, where a unit-linked contract provides for a *surrender value* equal to the value of the units allocated to the contract, the *firm* must establish *mathematical reserves* for that contract greater than or equal to the value of the units allocated at the valuation date.
- 1.2.63** **G** An option exists where a *policyholder* is given a choice between alternative forms of benefit, for example, a choice between receiving a cash benefit upon maturity or an annuity at a guaranteed rate. In some cases, the contract may designate one or other of these alternatives as the principal benefit and any other as an option. This designation, in itself, is not one of substance in the context of reserving since it does not affect the *policyholder's* choices. Other forms of option include:
- (1) the right to convert to a different contract on guaranteed terms;
  - (2) the right to increase cover on guaranteed terms;
  - (3) the right to a specified amount on surrender; and
  - (4) the right to a paid up value.
- 1.2.64** **G** The *firm* should provide for the benefit which the *firm* anticipates the *policyholder* is most likely to choose. Past experience may be used as a guide, but only if this is likely to give a reasonable estimate of future experience. For example, past experience of the take-up of a cash payment option instead of an annuity would not be a reliable guide, if, in the past, market rates exceeded those guaranteed in the annuity but no longer do so. Similarly, past experience on the take-up of options may not be relevant in

the light of the assumptions made in respect of future interest rates and mortality rates in the valuation of the benefits.

- 1.2.65** G Many options are long-term and need careful consideration. Improving longevity, for example, can increase the value of guaranteed annuity options vesting further in the future. *firms* also need to have regard to the fact that *policyholder* behaviour can change in the future as *policyholders* become more aware of the value of their options. The impact on *policyholder* behaviour of possible changes in taxation should also be considered.
- 1.2.66** G Take-up rates for guaranteed annuity options should be assessed on a prudent basis with assumptions that include margins for adverse deviation that take account of current experience and the potential for future change. The *firm* should reserve for option take-up at least at a prudent margin over current experience for options shortly to vest. For longer term options where the option becomes increasingly valuable in the future due to projected mortality improvements, increased take-up rates should be assumed. In view of the growing uncertainty over take-up rates for projections further in the future, for guaranteed annuity option dates 20 years or more ahead at least a 95% take-up rate assumption should be made.
- 1.2.67** G Where there is considerable variation in the cost of the option depending on conditions at the time the option is exercised, and where that variation constitutes a material risk for the *firm*, it will generally be appropriate to use stochastic modelling. In this case prices from the asset model used in the stochastic approach should be benchmarked to relevant market asset prices before determining the value of the option. Where stochastic modelling is not undertaken, market option prices should be used to determine suitable assumptions for the valuation of the option. If no market exists for a particular option, a *firm* should take the value of the nearest equivalent benefit or right for which a market exists and document the way in which it has adjusted that valuation to reflect the original option.
- 1.2.68** G Where the option offers a choice between two non-discretionary financial benefits (such as between a guaranteed cash sum or a guaranteed annuity value, or between a unit value and a maturity guarantee) and where there is a wide range of possible outcomes, the *firm* should normally model such liabilities stochastically. In carrying out such modelling *firms* should take into account the likely choices to be made by *policyholders* in each scenario. *Firms* should make and retain a record of the development and application of the model.
- 1.2.69** G The value of a contract with an option is greater than the value of a similar contract without the option, that is, the option has value whether it is expected to be exercised or not. Although in theory a *firm* can rebalance its investments to match the expected cost of the option to the *firm* (including the time value of the option), this takes time to achieve and the market may move more quickly than the *firm* is able to respond. Also, there are likely to be transaction costs. *Firms* should take these aspects into consideration in setting up *mathematical reserves*.

1.2.70

**R**

- (1) Where a *policyholder* may opt to be paid a cash amount, or a series of cash payments, the *mathematical reserves* for the *contract of insurance* must be sufficient to ensure that the payment or payments could be made solely from:
  - (a) the assets covering those *mathematical reserves*; and
  - (b) the resources arising from those assets and from the contract itself.
- (2) In (1) references to a cash amount or a series of cash payments include the amount or amounts likely to be paid on a voluntary discontinuance.
- (3) For the purposes of (1), the *firm* must assume that:
  - (a) the assumptions adopted for the current valuation remain unaltered and are met; and
  - (b) discretionary benefits and charges will be set so as to fulfil the *firm's* regulatory duty to treat its *customers* fairly.
- (4) (1) may be applied to a group of similar contracts instead of to the individual contracts within that group except where the cash amount or series of cash payments is the amount or amounts likely to be paid on a voluntary discontinuance.

1.2.71

**R**

For the purposes of ■ INSPRU 1.2.70 R, a *firm* must assume that the amount of a cash payment secured by the exercise of an option is:

- (1) in the case of an *accumulating with-profits policy*, the lower of:
  - (a) the amount which the *policyholder* would reasonably expect to be paid if the option were exercised, having regard to the representations made by the *firm* and including any expectations of a *final bonus*; and
  - (b) that amount, disregarding all discretionary adjustments;
- (2) in the case of any other *policy*, the amount which the *policyholder* would reasonably expect to be paid if the option were exercised, having regard to the representations made by the *firm*, without taking into account any expectations regarding future distributions of profits or the granting of discretionary additions in respect of an *established surplus*.

1.2.72

**G**

■ INSPRU 1.2.71R (1) applies only to *accumulating with-profits policies*;  
■ INSPRU 1.2.71R (2) applies to any other type of *policy*, including *non-profit insurance contracts*. In ■ INSPRU 1.2.71R (1)(a) a *firm* must take into consideration, for example, a market value adjustment where such an adjustment has been described in representations made to *policyholders* by the *firm*. However, any discretionary adjustment, such as a market value adjustment, must not be included in the amount calculated in  
■ INSPRU 1.2.71R (1)(b).

		<b>Reinsurance</b> .....
1.2.86	<b>R</b>	Future surplus may only be offset against future <i>reinsurance</i> cash outflow in respect of surplus on <i>non-profit insurance contracts</i> and the charges or shareholder transfers arising as surplus from <i>with-profits insurance contracts</i> . Such charges and transfers may only be allowed for to the extent consistent with the regulatory duty of the <i>firm</i> to treat its <i>customers</i> fairly.
1.2.90	<b>R</b>	[deleted]
1.2.91	<b>G</b>	[deleted]
		<b>Application of INSPRU 1.2 to Lloyd's</b> .....
1.2.92	<b>R</b>	

1.5

Internal-contagion risk

Application

- 1.5.1R■ INSPRU 1.5 applies to an *insurer* except any *insurer* in (1) to (3):  
  
(1) (a) *non-directive friendly societies*; or  
(b) *Solvency II firms*;  
  
(2) [deleted]  
  
(3) ■ INSPRU 1.5.33 R (payment of financial penalties) does not apply to *mutuals*.
- 1.5.4RIn its application to a *firm* with its head office in the *United Kingdom*, this section applies to the whole of the *firm's* business carried on world-wide.
- 1.5.5ARIn the application of this section to a *firm* with its head office outside the *United Kingdom*:  
  
(1) ■ INSPRU 1.5.13 R to ■ INSPRU 1.5.13B G apply in relation to the whole of its business carried on world-wide;  
  
(2) all other provisions of this section apply only in relation to activities carried on from a *branch* in the *United Kingdom*.
- 1.5.7GThe requirements of this section apply to a *firm* on a solo basis.



		<b>Purpose</b>
1.5.8	G	This section sets out requirements for a <i>firm</i> relating to 'internal-contagion risk'. This is the risk that losses or liabilities from one activity might deplete or divert financial resources held to meet liabilities from another activity. It arises where the two activities are carried on within the same <i>firm</i> . It may also arise from the combination of activities within the same <i>group</i> , but this aspect of internal-contagion risk falls outside the scope of this section.
1.5.9	G	Internal-contagion risk includes in particular the risk that arises where a <i>firm</i> carries on: <ul style="list-style-type: none"> <li>(1) both insurance and non-insurance activities; or</li> <li>(2) two or more different types of insurance activity; or</li> <li>(3) insurance activities from offices or <i>branches</i> located in both the <i>United Kingdom</i> and overseas.</li> </ul>
1.5.10	G	This section requires <i>firms</i> other than <i>pure reinsurers</i> to limit non-insurance activities to those that directly arise from their <i>insurance business</i> , e.g. investing assets, employing insurance staff etc. It also requires that an adequate provision be established for non-insurance liabilities. <i>pure reinsurers</i> must limit their activities to the business of <i>reinsurance</i> and related operations.
1.5.11	G	This section also sets out requirements for the separation of different types of insurance activity. However, in most circumstances the combination of different types of insurance activity within the same <i>firm</i> is a source of strength. Adequate pooling and diversification of insurance risk is fundamental to sound business practice. The requirements, therefore, only apply in two specific cases where without adequate protection the combination might operate to the detriment of <i>policyholders</i> . They apply where a <i>firm</i> carries on both: <ul style="list-style-type: none"> <li>(1) <i>general insurance business</i> and <i>long-term insurance business</i>;</li> <li>(2) linked and non-linked <i>insurance business</i>.</li> </ul>
1.5.12	G	Finally, the section sets out requirements to protect <i>policyholders</i> of the <i>United Kingdom branches</i> of <i>firms</i> with their head office outside the <i>United Kingdom</i> . <p><b>Restriction of business</b></p> <p><b>Requirements: Non-insurance activities</b></p>
1.5.13	R	<ul style="list-style-type: none"> <li>(1) A <i>firm</i> other than a <i>pure reinsurer</i> must not carry on any commercial business other than <i>insurance business</i> and activities directly arising from that business.</li> <li>(2) (1) does not prevent a <i>friendly society</i> which was on 15 March 1979 carrying on <i>long-term insurance business</i> from continuing to carry on savings business.</li> </ul>

- 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 1.5.13A R 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.
- Requirements: long-term insurance business**
- 1.5.16** G ■ INSPRU 1.5.18 R, ■ INSPRU 1.5.21 R, ■ INSPRU 1.5.30 R and ■ INSPRU 1.5.31 R require a *firm* to identify the assets attributable to the receipts of the *long-term insurance business*, called *long-term insurance assets*, and only to apply those assets for the purpose of that business. This has the effect of prohibiting a *composite firm* from using *long-term insurance assets* to meet *general insurance liabilities*. It also keeps *long-term insurance assets* separate from shareholder funds.
- Permissions not to include both types of insurance**
- 1.5.17** G
- (1) Under section 19 of the *Act*, a *firm* may not carry on a *regulated activity* unless it has *permission* to do so (or is exempt in relation to the particular activity). Both *general insurance business* and *long-term insurance business* are *regulated activities* and *permission* will extend to the *effecting* or *carrying out* of one or more particular *classes* of *contracts of insurance*.
  - (2) A *firm's permission* can be varied so as to add other *classes*. The *permission* of an existing *composite firm* may be varied by adding *classes* of both *general insurance business* and *long-term insurance business*.
  - (3) It is the policy of the *appropriate regulator* not to grant or vary *permission* if that would allow a newly established *firm*, or an existing *firm* engaging solely in *general insurance business* or solely in *long-term insurance business*, to engage in both *general insurance business* and *long-term insurance business*. This does not apply where a *firm's permission* to carry on *long-term insurance business* is or is to be restricted to *reinsurance*. It also does not apply where a *firm's permission* to carry on *general insurance business* is or is to be restricted to *effecting* or *carrying out* *accident or sickness contracts of insurance* .
  - (4) Where a *firm's permission* extends to *effecting* or *carrying out* *life and annuity contracts of insurance* this will normally include *permission* to *effect* or *carry out* *accident contracts of insurance* or *sickness contracts of insurance* on a supplementary basis.

**Separately identify and maintain long term insurance assets**

- 1.5.18** **R** A firm carrying on *long-term insurance business* must identify the assets relating to its *long-term insurance business* which it is required to hold by virtue of the requirements in the Non Solvency II firms: Insurance Company – Technical Provisions and Non-Solvency II firms: Insurance Company – Mathematical Reserves parts of the *PRA Rulebook*.
- 1.5.19** **G** The overall impact of the requirements in the *PRA Rulebook* to hold *admissible assets* of a value at least equal to the amount of *technical provisions*, when read together with **INSPRU 1.5.18R**, is that any firm writing *long-term insurance business* must identify separately assets of a value at least equal to the amount of its *long-term insurance business technical provisions*, including those in respect of any *property-linked liabilities* or *index-linked liabilities*, and its other *long-term insurance liabilities*.
- 1.5.20** **G** **INSPRU 1.5.18 R** does not prohibit a firm from identifying other assets as being available to meet the liabilities of its *long-term insurance business*. It may transfer such other assets to a *long-term insurance fund* (see **INSPRU 1.5.21 R** and **INSPRU 1.5.22 R**) and the transfer will take effect when it is recorded in the firm's accounting records (see **INSPRU 1.5.23 R**). After the transfer takes effect, a firm may not transfer the assets out of a *long-term insurance fund* except where they represent an *established surplus* (see **INSPRU 1.5.27 R**).
- 1.5.21** **R**
- (1) A firm's long-term insurance assets are the items in (2), adjusted to take account of:
    - (a) outgo in respect of the firm's *long-term insurance business*; and
    - (b) any transfers made in accordance with **INSPRU 1.5.27 R**.
  - (2) The items are:
    - (a) the assets identified under **INSPRU 1.5.18 R** (including assets into which those assets have been converted) but excluding any assets identified as being held to cover liabilities in respect of subordinated debt;
    - (b) any other assets identified by the firm as being available to cover its *long-term insurance liabilities* (including assets into which those assets have been converted) including, if the firm so elects, assets which are excluded under (a);
    - (c) *premiums* and other receivables in respect of *long-term insurance contracts*;
    - (d) other receipts of the *long-term insurance business*; and
    - (e) all income and capital receipts in respect of the items in (2).
- 1.5.22** **R**
- (1) Unless (2) applies, all the *long-term insurance assets* of the firm constitute its long-term insurance fund.
  - (2) Where a firm identifies particular *long-term insurance assets* in connection with different parts of its *long-term insurance business*, the assets identified in relation to each such part constitute separate long-term insurance funds of the firm.

- 1.5.23** **R** A *firm* must maintain a separate accounting record in respect of each of its *long-term insurance funds* (including any *with-profits fund*).
- 1.5.24** **G** *Firms* must ensure that *long-term insurance assets* are separately identified and allocated to a *long-term insurance fund* at all times. Assets in external accounts, for example at banks, custodians, or brokers should be segregated in the *firm's* books and records into separate accounts for *long-term insurance business* and *general insurance business*. Where a *firm* has more than one *long-term insurance fund*, a separate accounting record must be maintained for each fund. Accounting records should clearly document the allocation.
- 1.5.25** **G** Where the surplus arising from business is shared between *policyholders* and shareholders in different ways for different blocks of business, it may be necessary to maintain a separate fund to ensure that *policyholders* are, and will be, treated fairly. For example, if a proprietary company writes some business on a with-profits basis, this should be written in a *with-profits fund* separate from any business where the surplus arising from that business is wholly owned by shareholders.
- 1.5.26** **G** Where a *firm* merges separate funds for different types of business, it will need to ensure that the merger will not result in *policyholders* being treated unfairly. When considering merging the funds, the *firm* should consider the impact on its *PPFM* (see **■ COBS 20.3**) and on its obligations to notify the *FCA* (see **■ SUP 15.3**). In particular, a *firm* would need to consider how any *inherited estate* would be managed and how the fund would be run in future, such that *policyholders* are treated fairly.
- 1.5.27** **R** A *firm* may not transfer assets out of a *long-term insurance fund* unless:
- (1) the assets represent an *established surplus*; and
  - (2) no more than three months have passed since the determination of that surplus.
- 1.5.28** **G** As a result of **■ INSPRU 1.5.27R (2)**, an *actuarial investigation* undertaken to determine an *established surplus* remains in-date for three months from the date as at which the determination of the surplus was made. However, even where the investigation is still in-date, the *firm* should not make the transfer unless there is sufficient surplus at the time of the transfer to allow it to be made without breach of the requirements in *PRA Rulebook: Non Solvency II firms: Insurance Company – Technical Provisions*.
- 1.5.29** **G** **■ INSPRU 1.1.27 R** provides further constraints on the transfer of assets out of a *with-profits fund*. **■ INSPRU 1.1.27 R** requires a *firm* to have *admissible assets* in each of its *with-profits funds* to cover the *technical provisions* and other *long-term insurance liabilities* relating to all the business in that fund.

**Exclusive use of long-term insurance assets**

- 1.5.30** **R** (1) A *firm* must apply or use a *long-term insurance asset* only for the purposes of its *long-term insurance business*.
- (2) For the purpose of (1), applying or using an asset includes coming under any obligation (even if only contingently) to apply or use that asset.

- 1.5.31** **R** A *firm* must not agree to, or allow, any mortgage or charge on its *long-term insurance assets* other than in respect of, and for the purposes of, a *long-term insurance liability*.

- 1.5.32** **G** The purposes of the *long-term insurance business* include the payment of *claims*, expenses and liabilities arising from that business, the acquisition of lawful access to fixed assets to be used in that business and the investment of assets. The payment of liabilities may include repaying a loan but only where that loan was incurred for the purpose of the *long-term insurance business*. The purchase or investment of assets may include an exchange at fair *market value* of assets (including *money*) between the *long-term insurance fund* and other assets of the *firm*. A *firm* may also lend *securities* held in a *long-term insurance fund* under a *stock lending* transaction or transfer assets as *collateral* for a *stock lending* transaction where the *firm* is the borrower, where such lending or transfer is for the benefit of the *long-term insurance business*.

**Payment of financial penalties**

- 1.5.33** **R** If the *FCA* or *PRA* imposes a financial penalty on a *long-term insurer*, the *firm* must not pay that financial penalty from a *long-term insurance fund*.

- 1.5.34** **G**

**Requirements: property-linked funds**

- 1.5.35** **G** ■ INSPRU 3.1.57 R requires a *firm* to cover, as closely as possible, its *property-linked liabilities* by the property to which those liabilities are linked. In order to comply with this *rule*, a *firm* should identify the assets it holds to cover *property-linked liabilities* and should not apply those assets (as long as they are needed to cover the *property-linked liabilities*) for any purpose other than to meet those liabilities.

- 1.5.36** **R** A *firm* must select, allocate and manage the assets to which its *property-linked liabilities* are linked taking into account:
- (1) the *firm's* contractual obligations to holders of *property-linked policies*; and
- (2) its regulatory duty to treat *customers* fairly, including in the way it makes discretionary decisions as to how it selects, allocates and manages assets.

1

1.5.37 G *Property-linked liabilities* may be linked either to specified assets (with no contractual discretion given to the *firm* as to the choice of assets) or to assets of a specified kind where the selection of the actual assets is left to the *firm*.

1.5.58 R Application of INSPRU 1.5 to Lloyd's

1.5.59 R

INSPRU 1.2 (Mathematical reserves) and INSPRU 1.3 (With-profits insurance capital component)





## Chapter 2

# Credit risk in insurance



# Chapter 3

## Market risk



3.1 Market risk in insurance

- 3.1.1
- R
- INSPRU 3.1 applies to an *insurer*, unless it is:
- (1) a *non-directive friendly society*; or

(2) [deleted]

(3) [deleted]

(4) a *Solvency II firm*.

Purpose

- 3.1.7
- G
- INSPRU 3.1 addresses the impact of *market risk* on *insurance business* in the ways set out below:
- (1) Any *firm* that carries on *long-term insurance business* is required to hold capital to cover *market risk*. ■ INSPRU 3.1.26R makes particular provision for assets invested outside the *UK*.

(2) *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.

(3) ■ INSPRU 3.1.61AR(1) applies to *pure reinsurers* "prudent person" investment principles in relation to the investment of their assets.

### Market risk scenario for assets invested outside the United Kingdom

- 3.1.26** **R** Where the assets of a *firm* invested in a significant territory for the purposes of PRA Rulebook: Non-Solvency II firms: Capital Resources Requirements, 20.10, represent less than 0.5% of the *firm's long-term insurance assets* (excluding assets held to cover *index-linked liabilities* or *property-linked liabilities*), measured by *market value*, the *firm* may assume for those assets the *market risk* scenario for assets of that kind invested in the *United Kingdom* set out in PRA Rulebook: Non-Solvency II firms: Capital Resources Requirements, 20.10 instead of the other *market risk* scenarios set out in that provision.

### Covering linked liabilities

- 3.1.57** **R** A *firm* must cover its *property-linked liabilities* with:
- (1) (as closely as possible) the assets to which those liabilities are linked; or
  - (2) a *property-linked reinsurance* contract; or
  - (3) a combination of (1) and (2).

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

- 3.1.59** **G** For the purposes of **INSPRU 3.1.57 R** and **INSPRU 3.1.58 R**, a *firm* is not permitted to hold different assets and to cover the mismatch by holding excess assets.

- 3.1.60** **G** If a *firm* has incurred a *policy* liability which cannot be exactly matched by appropriate assets (for example the Limited Price Index (LPI)), the *firm* should seek to match assets that at least cover the liabilities. For example, an LPI limited to 5% per annum may be matched by an RPI bond or a fixed interest

investment matching cash flows increasing at 5% per annum compound. Orders made by the Department for Work and Pensions under section 148 of the Social Security Administration Act 1992, and which are limited to 5% per annum, may also be matched by a fixed interest investment matching cash flows increasing at 5% per annum compound.

**3.1.61** G In selecting the appropriate cover, the *firm* should ensure that both credit risk, and the risk that the value or yield in the assets will not, in all circumstances, match fluctuations in the relevant index, are within acceptable limits.

**3.1.61-A** G Where liabilities are linked to orders made under section 148 of the Social Security Administration Act 1992 the risks associated with the business may be mitigated by holding assets to cover an alternative index which is reasonably expected to at least cover the section 148 order (e.g. RPI plus a margin) over the duration of the link. The *firm's* exposure to an order under section 148 exceeding this index should be appropriately limited by putting a cap on the liabilities linked to the order so that risks are within acceptable limits.

**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.

#### Application of INSPRU 3.1 to Lloyd's

3.1.62

R



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) [deleted]
- (3) [deleted]
- (4) a *pure reinsurer*; or
- (5) a *Solvency II firm*.

3.2.2

G

[deleted]

3.2.3

R

- (1) This section applies to a *firm* in relation to the whole of its business, except where a particular provision provides for a narrower scope.
- (2) Where a *firm* carries on both *long-term insurance business* and *general insurance business*, this section applies separately to each type of business.

3.2.3A

G

[deleted]

Purpose

3.2.4

G

PRA Rulebook: Non-Solvency II firms: Insurance Company – Capital Resources 13 provides that a *derivative, quasi-derivative or stock lending transaction* will only be an *admissible asset* if it is approved. This section sets out the criteria for determining when a *derivative, quasi-derivative or stock lending transaction* is approved for this purpose. ■ INSPRU 3.2.5 R to ■ INSPRU 3.2.35 R set out the criteria for *derivatives* and *quasi-derivatives*. ■ INSPRU 3.2.36 R to ■ INSPRU 3.2.41 R set out the criteria for *stock lending transactions*.



## Derivatives and quasi-derivatives

### 3.2.5

**R**

For the purpose of *PRA Rulebook: Non-Solvency II firms: Insurance Company – Capital Resources 13 (Admissible assets in insurance)*, and also in relation to *permitted links*, a *derivative* or *quasi-derivative* is approved if:

- (1) it is held for the purpose of efficient portfolio management (■ INSPRU 3.2.6 R to ■ INSPRU 3.2.7 R) or reduction of investment risk (■ INSPRU 3.2.8 R to ■ INSPRU 3.2.13 G);
- (2) it is covered (■ INSPRU 3.2.14 R to ■ INSPRU 3.2.33 G); and
- (3) it is effected or issued:
  - (a) on or under the rules of a *regulated market*; or
  - (b) off-market with an *approved counterparty* and, except for a forward transaction, on approved terms and is capable of valuation (■ INSPRU 3.2.34 R to ■ INSPRU 3.2.35 R).

### 3.2.5A

**G**

- (1) *PRA Rulebook: Non-Solvency II firms: Insurance Company – Capital Resources 13.3* requires *firms* to consider first whether an asset is a *derivative* or *quasi-derivative* transaction notwithstanding that it is also capable of falling within one or more other categories in *PRA Rulebook: Non-Solvency II firms: Insurance Company – Capital Resources 13.1*. If it is a *derivative* or *quasi-derivative* transaction it is only admissible if it satisfies the conditions for it to be approved under ■ INSPRU 3.2.5 R. *Firms* should be able to justify whether or not their assets are *derivatives* or *quasi-derivatives*.
- (2) A *quasi-derivative* is defined as a contract or asset that has the effect of a *derivative* contract. *Quasi-derivatives* may be regarded as those contracts or assets which are not *derivatives* but which effectively contain an embedded *derivative* component which significantly impacts the contracts or assets cash flow and risk profile so as to mirror the economic effect of a *derivative*. A *derivative* is defined in the *Glossary* as a *contract for differences*, a *future* or an *option* and includes a *securitised derivative*, which is an *option* or *contract for differences* that is *listed*. A *securitised derivative* may also be a *debenture*.
- (3) A deposit with interest or other return calculated by reference to an index or other factor is excluded from the definition of *contract for differences* by article 85(2) of the *Regulated Activities Order*. However, if the return on the deposit is in the nature of that on a *derivative* (for example, an *option* or a *future*) then the deposit is a *quasi-derivative*.
- (4) A holding in a fund investing in *derivatives* may or may not be a *quasi-derivative* depending on its ongoing investment policy and governance and any investment decisions from time to time which might deviate significantly from the investment policy. It should be treated as a *quasi-derivative* if its risk profile is such that the value of *units* in the fund is expected to mirror the value of a *derivative*.
- (5) The assets in the following list, which is illustrative and not exhaustive, all have features which could lead to their being assumed to be *quasi-derivatives*:

- (a) a bond whose redemption proceeds are directly linked to the performance of the FTSE 100 index but with a guaranteed minimum;
- (b) an investment fund that is managed to give high leverage that mirrors a call option;
- (c) an investment whose value it is reasonably foreseeable could become negative; and
- (d) a credit-linked note, that is, a security with an embedded credit default swap.

### Efficient portfolio management

3.2.6

**R**

A *derivative* or *quasi-derivative* is held for the purpose of efficient portfolio management if the *firm* reasonably believes the *derivative* or *quasi-derivative* (either alone or together with any other covered transactions) enables the *firm* to achieve its investment objectives by one of the following (or, in relation to *permitted links*, in a manner which includes but is not limited to):

- (1) generating additional capital or income in one of the ways described in ■ INSPRU 3.2.7 R; or
- (2) reducing tax or investment cost in relation to *admissible assets* or *permitted links*; or
- (3) acquiring or disposing of rights in relation to *admissible assets* or *permitted links*, or their equivalent, more efficiently or effectively.

### Generation of additional capital or income

3.2.7

**R**

The generation of additional capital or income falls within ■ INSPRU 3.2.6R (1) where it arises from:

- (1) taking advantage of pricing imperfections in relation to the acquisition and disposal (or disposal and acquisition) of rights in relation to assets the same as, or equivalent to, *admissible assets* or *permitted links*; or
- (2) receiving a premium for selling a covered call *option* or its equivalent, the underlying of which is an *admissible asset* or *permitted link*, even if that additional capital or income is obtained at the expense of surrendering the chance of greater capital or income.

### Reduction of investment risk

3.2.8

**R**

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

### Significant increase in risk

3.2.9

**R**

For the purposes of ■ INSPRU 3.2.8 R, an increase in risk from a *derivative* or *quasi-derivative* is significant unless:

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

**3.2.10** G ■ INSPRU 3.2.8 R does not require that a *derivative* or *quasi-derivative* has no possible adverse consequences. Often a *derivative* or *quasi-derivative* is effected to protect against a severe adverse consequence that only arises in one circumstance. In all other circumstances it may itself lead to adverse consequences, even if only because it expires worthless resulting in the loss of the purchase price. Conversely a *derivative* or *quasi-derivative* may reduce risk in a wide range of circumstances but lead to adverse consequences when a particular circumstance arises, e.g. the default of the *counterparty*. Only rarely does a *derivative* or *quasi-derivative* give rise to no adverse consequences in any circumstances. The test is merely that the increase in risk should not be significant, that is it should be both small and reasonable, or the risk should be remote.

**3.2.11** G [deleted]

### Investment risk

**3.2.12** R For the purposes of ■ INSPRU 3.2.8 R, investment risk is the risk that the assets held by a *firm*:

- (1) (where they are *admissible assets* held by the *firm* to cover its *technical provisions*) might not be:
  - (a) of a value at least equal to the amount of those *technical provisions* as required by PRA Rulebook: Non-Solvency II firms: Insurance Company – Technical Provisions, 4; or
  - (b) of appropriate safety, yield and marketability as required by PRA Rulebook: Non-Solvency II firms: Insurance Company – Technical Provisions, 6.2(1); or
  - (c) of an appropriate currency match as required by PRA Rulebook: Non-Solvency II firms: Insurance Company – Risk Management, 3.2;
- (2) (where they are held to cover *index-linked liabilities*) might not be appropriate cover for those liabilities as required by ■ INSPRU 3.1.58 R; and
- (3) (where they are held to cover *property-linked liabilities*) might not be appropriately selected in accordance with contractual and constructive liabilities and appropriate cover for those liabilities as required by PRA Rulebook: Non-Solvency II firms: Insurance Company – Risk Management, in particular the definition of ‘investment risk’.

**3.2.13** G In assessing whether investment risk is reduced, the impact of a transaction on both the assets and liabilities should be considered. In particular, where the amount of liabilities depends upon the fluctuations in an index or other factor, investment risk is reduced where assets whose value fluctuates in the

same way match those liabilities. In appropriate circumstances this may include:

- (1) a *derivative* or *quasi-derivative* that is linked to the same index as the liabilities from the index-linked contracts; and
- (2) a *derivative* or *quasi-derivative* whose value depends upon the factors which give rise to general insurance claims, e.g. a weather *quasi-derivative*.

### Cover

- 3.2.14** **R** A *firm* must cover an obligation to transfer assets or pay monetary amounts that arises from:
- (1) a *derivative* or *quasi-derivative*; or
  - (2) a contract (other than a *contract of insurance*) for the purchase, sale or exchange of assets.
- 3.2.15** **R** An obligation to transfer assets or pay monetary amounts (see ■ INSPRU 3.2.14 R) must be covered:
- (1) by assets, a liability or a provision (see ■ INSPRU 3.2.16 R to ■ INSPRU 3.2.24 R); or
  - (2) by an offsetting transaction (see ■ INSPRU 3.2.25 R to ■ INSPRU 3.2.27 R).
- 3.2.16** **R** An obligation to transfer assets (other than *money*) or to pay monetary amounts based on the value of, or income from, assets is covered if the *firm* holds:
- (1) those assets; or
  - (2) in the case of an index or basket of assets, a reasonable approximation to those assets.
- 3.2.17** **R** An obligation to pay a monetary amount (whether or not falling in ■ INSPRU 3.2.16 R) is covered if:
- (1) the *firm* holds *admissible assets* or *permitted links* that are sufficient in value so that the *firm* reasonably believes that following reasonably foreseeable adverse variations (relying solely on cashflows from, or from realising, those assets) it could pay the monetary amount in the right currency when it falls due; or
  - (2) the obligation to pay the monetary amount is offset by a liability. An obligation is offset by a liability where an increase in the amount of that obligation would be offset by a decrease in the amount of that liability; or
  - (3) a provision at least equal to the value of the assets in (1) is implicitly or explicitly set up. A provision is implicitly set up to the extent that the obligation to pay the monetary amount is recognised under PRA Rulebook: Non Solvency II firms: Insurance Company – Overall Resources and Valuation, in particular chapters 3-7, either by offset against an asset or as a separate liability. A provision is explicitly set up if it is in addition to an implicit provision.

- 3.2.18** **R** A *firm* must implicitly or explicitly set up a provision equal to the value of the assets or offsetting transactions held to cover a non-approved *derivative* or *quasi-derivative* transaction.
- 3.2.19** **G** A *firm* is required to cover a *derivative* under ■ INSPRU 3.2.14R whether it satisfies the other conditions for approval under ■ INSPRU 3.2.5R or not. Under ■ INSPRU 3.2.17R a *firm* may cover an obligation to pay a monetary amount by setting up a provision. If the *derivative* is not covered at any time by other means then a provision needs to be set up to complete the cover taking into account obligations to pay monetary amounts that would arise if, for example, an obligation to transfer assets could not be met in full. By doing so, a *derivative* becomes covered. If it satisfies the other conditions under ■ INSPRU 3.2.5R it is an *approved derivative* and may be taken into account for solvency purposes to the extent permitted by the large exposure limits and market risk and counterparty limits.
- 3.2.20** **G** Exposure to a transaction includes exposure that arises from a right at the *firm's* (or its *subsidiary undertaking's*) option to dispose of assets.
- 3.2.21** **G** Cover serves three purposes. First, it protects against exposure to loss from the transaction which is being covered. The value of the cover increases (or if the cover is a liability the amount of that liability decreases) to match any increase in obligations under the transaction.
- 3.2.22** **G** The second purpose of cover is that it prevents excessive gearing in the investment portfolio by the use of *options* and their equivalent. A *firm* is required to cover all obligations under an admissible transaction including obligations that would arise only at the option of the *firm*, e.g. the liability to pay the exercise price under a bought *option*.
- 3.2.23** **G** The third purpose of cover is that it protects against the risk that the *firm* may not be able to deliver assets (including *money* in any currency) of the right type when the obligation falls due under the transaction. An obligation to deliver assets is covered only if the *firm* holds those assets or has entered into an offsetting transaction that would deliver those assets when needed. An obligation to pay *money* is offset only if the *firm* holds cash in the right currency, its equivalent or assets that could reliably be converted into cash in the right currency.
- 3.2.24** **R** Cover used for one transaction must not be used for cover in respect of another transaction or any other agreement to acquire, or dispose of, assets or to pay or repay *money*.
- Offsetting transactions** .....
- 3.2.25** **R** An offsetting transaction means:
- (1) an *approved derivative*, *approved stock lending transaction* or an *approved quasi-derivative*; or

- (2) a covered transaction with an *approved counterparty* for the purchase of assets.

**3.2.26** **R** A transaction offsets an obligation to transfer assets away from the *firm* only if it provides for the transfer to the *firm* of those assets, or their value, at the time, or before, the obligation falls due.

**3.2.27** **R** A transaction offsets an obligation to pay a monetary amount only if it provides for that monetary amount to be paid to the *firm* at or before the earliest date on which the obligation might fall due.

### Lending and borrowing assets

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

- (1) they are non-monetary assets that have been lent under a transaction that fulfils the conditions in **INSPRU 3.2.36 R**; and
- (2) the *firm* reasonably believes the assets to be obtainable (by return or re-acquisition) in time to meet the obligation for which cover is required.

**3.2.29** **R** Assets that have been borrowed by the *firm* are not available for cover except as allowed by **INSPRU 3.2.30 R**.

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

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

**3.2.31** **G** **INSPRU 3.2.30 R** in effect allows borrowings to be used to bridge the gap between an obligation under a transaction that might fall due at one date and cash or its equivalent that would only become due at a later date. Borrowings may not be used to gear the investment portfolio.

### Examples of cover requirements

**3.2.32** **G** Examples of cover by assets for the purposes of **INSPRU 3.2.16 R**:

- (1) a bought put *option* (or a sold call *option*) on 1000 1 *shares* (fully paid) of ABC plc is covered by an existing holding in the fund of 1000 1 *shares* (fully paid) of ABC plc;
- (2) a bought call *option* (or sold put *option*) on 1000 ordinary 1 *shares* (fully paid) of ABC plc is covered by cash (or its equivalent) which is sufficient in amount to meet the purchase price of the *shares* on exercise of the *option*;
- (3) a bought or sold *contract for differences* on short-dated sterling is covered by cash (or its equivalent), the value of which together at

least match the notional principal of the contract. For example, a LIFFE short sterling contract, or a successive series of such contracts, is covered by 500,000; and

- (4) a sold *future* on the FT-SE 100 index is covered by holdings of equities, which satisfy the reasonable approximation test for cover in ■ INSPRU 3.2.16R (2) in relation to that *future*, and the values of which together at least match the current mark to market valuation of the *future*. For example, if the multiplier per full point is 10, and if the eventual obligation under the *future* is currently 2800, the valuation of the *futures* position is  $2800 \times 10 = 28,000$ .

- 3.2.33 G Examples of cover by offsetting transactions for the purpose of ■ INSPRU 3.2.25 R would include a bought *future* which is guaranteed to deliver to the *firm* at the relevant time sufficient assets to cover liabilities under a sold call *option*.

#### Off-market transactions

- 3.2.34 R For the purpose of ■ INSPRU 3.2.5R (3)(b), a *derivative* or *quasi-derivative* is on approved terms only if the *firm* reasonably believes that it could, in all reasonably foreseeable circumstances and under normal market conditions, readily enter into a further transaction with the *counterparty* or a third party to close out the *derivative* or *quasi-derivative* at a price not less than the value attributed to it by the *firm*, taking into account any valuation adjustments or reserves established by the *firm* under PRA Rulebook: Non-Solvency II firms: Insurance Company – Overall Resources and Valuation, in particular chapter 7.

- 3.2.34A G In considering whether the first transaction could be readily closed out in all reasonably foreseeable circumstances under normal market conditions, the *firm* should satisfy itself that it cannot reasonably foresee any circumstances in which it would need to close out all or part of the contract at a few days' notice, and would not be able to do so.

- 3.2.35 R For the purpose of ■ INSPRU 3.2.5R (3)(b), a *derivative* or *quasi-derivative* is capable of valuation only if the *firm*:
- (1) is able to value it with reasonable accuracy on a reliable basis in compliance with PRA Rulebook: Non-Solvency II firms: Insurance Company – Overall Resources and Valuation, 3.1; and
  - (2) reasonably believes that it will be able to do so throughout the life of the transaction.

- 3.2.35A G The purpose of ■ INSPRU 3.2.34 R and ■ INSPRU 3.2.35 R is to ensure the appropriate application of PRA Rulebook: Non-Solvency II firms: Insurance Company – Overall Resources and Valuation, to *derivatives* and *quasi-derivatives* effected or issued off-market with an *approved counterparty*.



### Stock lending

3.2.36

R

- (1) For the purposes of *PRA Rulebook: Non-Solvency II firms: Insurance Company – Capital Resources 13* (Admissible assets in insurance), a *stock lending* transaction (including a *repo* transaction) is approved if:
  - (a) the assets lent are *admissible assets*;
  - (b) , the *counterparty* is an *authorised person*, an *approved counterparty*, a *person* registered as a broker-dealer with the Securities and Exchange Commission of the United States of America or 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:
    - (i) the Office of the Comptroller of the Currency;
    - (ii) the Federal Deposit Insurance Corporation;
    - (iii) the Board of Governors of the Federal Reserve System; and
  - (c) adequate and sufficiently immediate *collateral* (■ [INSPRU 3.2.38 R](#) to ■ [INSPRU 3.2.41 R](#)) is obtained to secure the obligation of the *counterparty*.
- (2) ■ [INSPRU 3.2.36R \(1\)\(c\)](#) does not apply to a *stock lending* transaction made through Euroclear Bank SA/NV's Securities Lending and Borrowing Programme.

3.2.36A

R

- (1) For the purposes of the *rules on permitted links*, a *stock lending* transaction (including a *repo* transaction) is approved if:
  - (a) the assets lent are *permitted links*;
  - (b) the *counterparty* is an *authorised person*, an *approved counterparty*, a *person* registered as a broker-dealer with the Securities and Exchange Commission of the United States of America or 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 in the United States of America:
    - (i) the Office of the Comptroller of the Currency;
    - (ii) the Federal Deposit Insurance Corporation;
    - (iii) the Board of Governors of the Federal Reserve System; and
  - (c) adequately and sufficiently immediate *collateral* (■ [INSPRU 3.2.38 R](#) to ■ [INSPRU 3.2.41 R](#)) is obtained to secure the obligation of the *counterparty*; and
  - (d) provided that, 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, they must receive 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 must be disclosed to them; and
    - (iii) where the risk associated with the *stock lending* transaction is borne outside the *linked fund*, the *linked fund* should



receive a fair and reasonable recompense for the use of the *linked policyholders'* funds.

- (2) ■ INSPRU 3.2.36R (1)(c) does not apply to a *stock lending* transaction made through Euroclear Bank SA/NVs Securities Lending and Borrowing Programme.

3.2.37

G

■ INSPRU 3.2.36 R refers only to *stock lending* transactions where the *firm* is the lender. There are no special *rules* for a transaction under which the *firm* borrows securities.

### Collateral

3.2.38

R

For the purposes of ■ INSPRU 3.2.36R (1)(c), *collateral* is adequate only if it:

- (1) is transferred to the *firm* or its agent or, in the case of a letter of credit, meets the conditions described in ■ INSPRU 3.2.38A R;
- (2) is, at the time of the transfer or, in the case of a letter of credit, at the time of issue, at least equal in value to the value of the securities transferred, or consideration provided, by the *firm*; and
- (3) is of adequate quality.

3.2.38A

R

The conditions referred to in ■ INSPRU 3.2.38R (1) are that the letter of credit is:

- (1) direct, explicit, unconditional and irrevocable; and
- (2) issued by an *undertaking* which is:
  - (a) not a *related undertaking* of the *counterparty*; and
  - (b) either an *approved credit institution* or a bank, or a branch of a bank, whether chartered by the federal government of the United States of America or a US state, that is supervised and examined by at least one of the following US federal banking supervisory authorities:
    - (i) the Office of the Comptroller of the Currency;
    - (ii) the Federal Deposit Insurance Corporation;
    - (iii) the Board of Governors of the Federal Reserve System

3.2.39

G

For the purposes of assessing adequate quality in ■ INSPRU 3.2.38R (3), reference should be made to the criteria for credit risk loss mitigation set out in ■ INSPRU 2.1.16 R. The valuation rules in *PRA Rulebook: Non-Solvency II firms: Insurance Company – Overall Resources and Valuation* apply for the purpose of determining the value of both *collateral* received, and the *securities* transferred, by the *firm*. In addition, where *collateral* takes the form of assets transferred, under the *rules* in the *PRA Rulebook: Non-Solvency II firms: Insurance Company – Capital Resources 13* any such asset that is not an *admissible asset* does not have a value.

- 3.2.40** **R** For the purposes of ■ INSPRU 3.2.36R (1)(c), *collateral* is sufficiently immediate only if:
- (1) it is transferred or, in the case of a letter of credit, issued before, or at the same time as, the transfer of the *securities* by the *firm*; or
  - (2) it will be transferred or, in the case of a letter of credit, issued, at latest, by the close of business on the day of the transfer.
- 3.2.41** **R** *Collateral* continues to be adequate only if its value is at all times at least equal to the value of the *securities* transferred by the *firm*. This will be satisfied in respect of *collateral* where the validity of the *collateral* or the *firm's* interest in the *collateral* is about to expire or has expired if sufficient *collateral* will again be transferred or issued at the latest by the close of business on the day of expiry.
- 3.2.42** **G** References in ■ INSPRU 3.2.40R (2) and ■ INSPRU 3.2.41 R to the close of business on the day of the transfer or the day of expiry are to close of business on that day in all time regions.

## Chapter 4

# Liquidity risk management



## Chapter 5

# Operational Risk Management



## Chapter 6

# Group Risk: Insurance Groups



6.1 Application

Purpose

6.1.5A G

Calculation of GCR - Deductions under requirement deduction method from group capital resources

6.1.64A R



## Chapter 7

# Individual Capital Assessment



7.1 Application

Calculation of GCR - Assets in excess of market risk and counterparty exposure limits

- 7.1.3A G The rules and guidance in ■ INSPRU 7.1 are made by the FCA solely for the purpose of their application to *dormant account fund operators*.
- 7.1.3B G References in this chapter to *GENPRU*, *INSPRU*, and connected terms, are to the provisions in force as at 31 December 2015. References in this chapter to the *appropriate regulator* are to the FCA.

Purpose

- 7.1.4 G Principle 4 requires a *firm* to maintain adequate financial resources. ■ GENPRU 2 deals specifically with the adequacy of the *capital resources* element of a *firm's* financial resources.
- 7.1.5 G The adequacy of a *firm's capital resources* needs to be assessed both by the firm and the *appropriate regulator*. In ■ GENPRU 2.1, the *appropriate regulator* sets minimum *capital resources requirements* for firms.
- 7.1.6 G The *appropriate regulator* also assesses whether the minimum *capital resources requirements* are appropriate by reviewing:
  - (1) a *firm's* own assessment of its capital needs; and
  - (2) the processes and systems by which that assessment is made.
- 7.1.7 G In assessing whether the minimum *capital resources requirements* are appropriate, the *appropriate regulator* is principally concerned with capital resources as calculated in accordance with ■ GENPRU 2.2.17 R. However, in carrying out its own assessment of its capital needs, a *firm* may take into account other capital available to it (see ■ GENPRU 1.2.30 R and ■ GENPRU 1.2.36 R), although it should be able to explain and justify its reliance on these other forms of capital.

7.1.8	G	<p>There are two main aims in this section:</p> <ol style="list-style-type: none"> <li>(1) to enable <i>firms</i> to understand the issues which the <i>appropriate regulator</i> would expect to see assessed and the systems and processes which the <i>appropriate regulator</i> would expect to see in operation for ICAs by <i>firms</i> to be regarded as thorough, objective and prudent; and</li> <li>(2) to enable <i>firms</i> to understand the <i>appropriate regulator's</i> approach to assessing whether the minimum <i>capital resources requirements</i> of ■ GENPRU 2.1 are appropriate and what action may be taken if the <i>appropriate regulator</i> concludes that those requirements are not appropriate to a <i>firm's</i> circumstances.</li> </ol> <p><b>General approach</b></p>
7.1.9	G	<p>The <i>rules</i> in ■ GENPRU 1.2 require a <i>firm</i> to identify and assess risks to its being able to meet its liabilities as they fall due, to assess how it intends to deal with those risks and to quantify the financial resources it considers necessary to mitigate those risks. To meet these requirements, a <i>firm</i> should consider:</p> <ol style="list-style-type: none"> <li>(1) the extent to which capital is an appropriate mitigant for the risks identified; and</li> <li>(2) assess the amount and quality of capital required.</li> </ol>
7.1.9A	G	<p>This section sets out in greater detail the approach to be taken by a <i>firm</i> when carrying out the assessment of capital described in the preceding paragraph. This is the assessment referred to as an <i>individual capital assessment</i>. ■ GENPRU 1.2.42 R is a general requirement for a <i>firm</i> to carry out stress tests and scenario analyses taking into account an appropriate range of adverse circumstances and events relevant to the <i>firm's</i> business and risk profile and to estimate the financial resources it would need to continue to meet the <i>overall financial adequacy rule</i> in the stress scenarios considered. As part of its obligations under ■ GENPRU 1.2.42 R, the <i>firm</i> must carry out stress tests and scenario analyses to estimate the financial resources it would need to support its business plans and continue adequately to cover its CRR and meet the <i>overall financial adequacy rule</i> over a time horizon of 3 to 5 years. This is a separate requirement from that to carry out an ICA, and <i>guidance</i> on this requirement is provided in ■ GENPRU 1.2.73A G and ■ GENPRU 1.2.73C G. In particular, <i>firms</i> should note that there is no requirement that the level of capital required as identified by the ICA should be equal to, or exceed, the CRR.</p>
7.1.9B	G	<p>The requirements and <i>guidance</i> in this section are drafted so as to apply to a <i>firm</i> on a solo basis. As noted in ■ GENPRU 1.2.17 G, however, in some cases the requirements in ■ GENPRU 1.2 apply on a consolidated basis. In these cases, a <i>firm</i> should read and apply this section making appropriate adjustments to reflect the application of the ■ GENPRU 1.2 requirements on a consolidated basis.</p>
7.1.10	G	<p>A <i>firm</i> may choose to carry out its ICA in another way than through the use of stress tests and scenario analyses. The method should be proportionate to the size and nature of its business.</p>

- 7.1.11 **G** In accordance with ■ GENPRU 1.2.60 R, these assessments must be documented so that they can be easily reviewed by the *appropriate regulator* as part of the *appropriate regulator's* assessment of the adequacy of the *firm's capital resources*.
- 7.1.12 **G** The *appropriate regulator* may ask for the results of these assessments to be provided to it together with a description of the processes by which the assessments have been made, the range of results from each stress test or scenario analysis performed and the main assumptions made. The *appropriate regulator* may also carry out a more detailed examination of the details of the *firm's* processes and calculations.
- 7.1.13 **R** Based upon this information and other information available to it, the *appropriate regulator* will consider whether the *capital resources requirement* applicable to the firm is appropriate. Where relevant, the *firm's ECR* will be a key input to the *appropriate regulator's* assessment of the adequacy of the *firm's capital resources*. For *firms* carrying on *general insurance business*, the *ECR* is calculated in accordance with ■ INSPRU 1.1.72C R.
- 7.1.14 **G** *Firms* that are required to calculate an *ECR* may wish to note that the *ECR* as calculated is based upon the assumptions that a *firm's* business is well diversified, well managed with assets matching its liabilities and good controls, and stable with no large, unusual, or high risk transactions. *Firms* may find it helpful to assess the extent to which their actual business differs from these assumptions and therefore what adjustments it might be reasonable to make to the *CRR* or *ECR* to arrive at an adequate level of *capital resources*.
- Methodology of capital resources assessment**
- 7.1.15 **R** Where a *firm* is carrying out an assessment in accordance with ■ GENPRU 1.2 of the adequacy of its overall financial resources to cover the risk in the *overall financial adequacy rule*, that is, the risk of its being unable to meet its liabilities as they fall due, the assessment of the adequacy of the *firm's* capital resources must:
- (1) reflect the *firm's* assets, liabilities, intra-group arrangements and future plans;
  - (2) be consistent with the *firm's* management practice, systems and controls;
  - (3) consider all material risks that may have an impact on the *firm's* ability to meet its liabilities to *policyholders*; and
  - (4) use a valuation basis that is consistent throughout the assessment.
- Representative of the firm's characteristics**
- 7.1.16 **G** The *ICA* should reflect both the *firm's* desire to fulfil its business objectives and its responsibility to meet liabilities to *policyholders*. This means that the *ICA* should demonstrate that the *firm* holds sufficient capital to be able to

- make planned investments and take on new business (within an appropriate planning horizon). It should also ensure that if the *firm* had to close to new business (if it has not already done so), it would be able to meet its existing commitments. The costs of writing new business, the expenses incurred in servicing all liabilities, including liabilities to non-*policyholders*, and the nature of intra-group arrangements and *reinsurance* arrangements should be considered as part of the assessment as well as the costs that would be incurred in the event of closure to new business.
- 7.1.17 **G** Where a *firm* has not already closed to new business, the *ICA* should be made on the basis that the *firm* closes to new business after an appropriate period. This period should allow for the time it would take for the *firm* to identify the need for closure and to implement the necessary action.
- 7.1.18 **G** Where including new business would increase the capital resources by more than any increase in the capital required, or reduce the capital required by more than any reduction in available capital, new business should be excluded. To the extent that including new business increases the required capital, a *firm* should consider whether it is appropriate to include the additional amount within the *ICA*.
- 7.1.19 **G** Any contract that the *firm* is legally obliged to renew should be considered part of the *firm's* existing liabilities and not treated as new business. Such contractual obligations include multi-year *general insurance contracts* and the exercise of options by long-term *policyholders*.
- 7.1.20 **G** For a *firm* to discharge its financial obligations to *policyholders*, it will incur certain expenses, including payments to the *firm's* own staff, contributions to any pension scheme and fees to outsourcing suppliers or service companies. All of these expenses, and risks associated with these payments, should be considered when carrying out the *ICA*. When considering the appropriate level of expenses in a projection, the *firm* should consider the acceptability of the service provided to *policyholders* and the resources required by the senior management to manage the *firm*.
- 7.1.21 **G** Where a *firm's* liabilities include payments which are subordinated to liabilities to *policyholders*, these payments do not need to be included within the *ICA*. However, the *ICA* should include all payments that must be made to avoid putting *policyholders'* interests at risk, including any payment on which a default might trigger the winding up of the *firm*. For example, if the principal of a loan could be recalled on default of a coupon payment, coupon payments over the lifetime of *policyholder* liabilities should be included in the *ICA*. As a further example, declared dividends should be treated as a liability. However, planned dividends that have not been declared need not be included in the *ICA*.
- Consistency with a firm's practice, systems and controls**.....
- 7.1.25 **G** The *ICA* should reflect the *firm's* ability to react to events as they occur. When relying on prospective management actions, *firms* should understand the implications of taking such actions, including the financial effect, and

- p>
taking into consideration any preconditions that might affect the value of management actions as risk mitigants.
- 7.1.26 **G** The *ICA* should assume that a *firm* will continue to manage its business having regard to the *PRA's* and *FCA's* Principles for Businesses. In particular, a *firm* should take into account how the Principles for Businesses may constrain its prospective management actions, for example, the *FCA's* Principle 6 (Treating Customers Fairly).
- 7.1.26A **G**
- 7.1.27 **G** *Firms* should also consider whether their systems and controls provide sufficient information to permit senior management to identify the crystallisation of risks in a timely manner so as to provide them with the opportunity to respond and allow the *firm* to obtain the full value of the modelled management action. *Firms* should also analyse the wider implications of the management actions, particularly where they represent significant divergence from the business plan and use this information to consider the appropriateness of taking this action.
- Considering all material risks**
- 7.1.29 **G** The *ICA* should give the required level of confidence that the *firm's* liabilities to *policyholders* will be paid. The *ICA* should consider all material risks which may arise before the *policyholder* liabilities are paid (including those risks set out in ■ GENPRU 1.2.30 R).
- 7.1.30 **G** *Firms* should not ignore risks simply because they relate to events that occur with an expected likelihood beyond the confidence level. However, the capital required in the face of these tail events may be reduced for the purpose of carrying out the *ICA*. For example, while an A-rated bond may be assumed not to default within the required confidence level, allowance should be made for the devaluation of that bond through a more likely downgrade or change in credit spreads or other method which reflects that this investment includes a default risk to the *firm*.
- 7.1.31 **G** Notwithstanding ■ INSPRU 7.1.30 G, risks which have an immaterial effect on the *firm's* financial position or only occur with an extreme probability may be excluded from the *ICA*.
- 7.1.32 **G** The number of *claims*, the amount paid and the timing of a *firm's* liabilities may be uncertain. The *ICA* should consider risks which result in a change in the cost of those liabilities.
- 7.1.33 **G** The assets that a *firm* holds will include assets to back both the liabilities and any capital requirement. These assets carry risk, both in their own right and to the extent that they do not match the liabilities that they are backing. The risk associated with these assets should be considered over the full term for which the *firm* expects to carry the liabilities.

- 7.1.34 **G** Where the *firm* is relying on systems and controls in order to mitigate risks, the *firm* should consider the risk of those systems and controls failing at the confidence level at which the *ICA* is being carried out.
- 7.1.35 **G** If a *firm* summarises cash flows over part of the lifetime of the portfolio using a balance sheet but is exposed to risks which emerge after the balance sheet date, then these longer-dated risks may be captured by adjusting the assumptions used in the closing balance sheet.

Valuation basis

- 7.1.36 **G** The valuation of the assets and of the liabilities should reflect their economic substance. A realistic valuation basis should be used for assets and liabilities taking into account the actual amounts and timings of cash flows under any projections used in the assessment.
- 7.1.37 **G** In carrying out the *ICA*, wherever possible the value of assets should be marked to market. Where marking to market is not possible, the *ICA* should use a method suitable for assessing the underlying economic benefit of holding each asset.
- 7.1.38 **G** The methods and assumptions used in valuing the liabilities should contain no explicit margins for risk, nor should the approach be optimistic. The valuation of liabilities should be consistent with the valuation of assets. To the extent the market price includes an implicit allowance for risk, this should be included within the valuation.
- 7.1.39 **G** The methodology used to place a value on an asset or a liability following a risk event should be consistent with the methodology used prior to the risk event.
- 7.1.40 **G** Approximate valuation methods may be used by the *firm* for minor lines of business or to capture less material types of risk. However, the *firm* should avoid methods which under-estimate the risk in aggregate.
- 7.1.41 **G** The *firm* should carry out a broad reconciliation of key parts of any balance sheet used in the *ICA* with the corresponding entry from audited results.

ICA submitted to appropriate regulator: confidence level

- 7.1.42 **R** Where the *appropriate regulator* requests a *firm* to submit to it a written record of the *firm's* assessments of the adequacy of its capital resources carried out in accordance with **INSPRU 7.1.15 R**, those assessments must include an assessment comparable to a 99.5% confidence level over a one year timeframe that the value of assets exceeds the value of liabilities, whether or not this is the confidence level otherwise used in the *firm's* own assessments.

- 7.1.43** **G** In considering the value of liabilities for the purpose of ■ INSPRU 7.1.42 R, *firms* should have regard to the guidance in ■ INSPRU 7.1.21 G, ■ INSPRU 7.1.26 G and ■ GENPRU 1.2.27 G to ■ GENPRU 1.2.29 G.
- 7.1.44** **G** The *appropriate regulator* requires *firms* to submit a capital assessment calibrated to a common confidence level, as set out in ■ INSPRU 7.1.42 R, to enable the *appropriate regulator* to assess whether the minimum *capital resources requirements* in ■ GENPRU 2.1 are appropriate. This then allows the *appropriate regulator* to give a consistent level of *individual capital guidance* across the industry.
- 7.1.45** **G** If a *firm* selects a longer time horizon than one year it may choose to use a lower confidence level than 99.5%. In such a case, the *firm* should be prepared to justify its choice and explain why this confidence interval is appropriate and how it is comparable to a 99.5% confidence level over a one year timeframe. An assessment based on a longer timeframe should also demonstrate that there are sufficient assets to cover liabilities at all future dates. This may be illustrated by future annual balance sheets.
- Measurement**
- 7.1.46** **G** In determining the strength of the *ICA*, a *firm* should consider all risks in aggregate making appropriate allowance for diversification such that the assessment meets the required confidence level overall. The *firm* should be able to describe and explain each of the main diversification benefits allowed for.
- 7.1.47** **G** For risks that can be observed to crystallise over a short period of the order of a year, the confidence level may be measured with reference to the probability distribution for the impact of the risks over one year. For example, catastrophic events such as hurricanes can be measured in this way by estimating the ultimate capital cost.
- 7.1.48** **G** For risks that are not observable over a short period (such as long-tailed liability business or annuitant mortality), the confidence level may be measured with reference to the probability distribution for the emergence of that risk over the lifetime of the liabilities.
- Documenting ICAs submitted to the appropriate regulator**
- 7.1.49** **R** The written record of a *firm's individual capital assessments* carried out in accordance with ■ INSPRU 7.1.15 R submitted by the *firm* to the *appropriate regulator* must:
- (1) in relation to the assessment comparable to a 99.5% confidence level over a one year timeframe that the value of assets exceeds the value of liabilities, document the reasoning and judgements underlying that assessment and, in particular, justify:
    - (a) the assumptions used;
    - (b) the appropriateness of the methodology used; and
    - (c) the results of the assessment; and



- (2) identify the major differences between that assessment and any other assessments carried out by the *firm* using a different confidence level.

### Appropriate regulator assessment process - all firms

- 7.1.91** G In assessing the adequacy of a *firm's capital resources*, the *appropriate regulator* draws on more than just a review of the submitted *ICA*. Use is made of wider supervisory knowledge of a *firm* and of wider market developments and practices. When forming a view of any *individual capital guidance* to be given to a *firm*, the review of the *firm's ICA* along with the regulator's risk assessment and any other issues arising from day-to-day supervision will be considered.
- 7.1.92** G The *appropriate regulator* will take a risk-based and proportionate approach to the review of a *firm's ICA*, focusing on the *firm's* approach to dealing with the key risks it faces. Any *individual capital guidance* given will reflect the judgements reached through the regulator's review process as well as the review of the *firm's ICA*.
- 7.1.93** G A *firm* should not expect the *appropriate regulator* to accept as adequate any particular model that the *firm* develops or that the results from the model are automatically reflected in any *individual capital guidance* given to the *firm* for the purpose of determining adequate *capital resources*. However, the *appropriate regulator* will take into account the results of any sound and prudent model when giving *individual capital guidance* or considering applications for a waiver under sections 138A and 138B of the Act of the *capital resources requirement* in ■ GENPRU 2.1.
- 7.1.94** G Where the *appropriate regulator* considers that a *firm* will not comply with ■ GENPRU 1.2.26 R (adequate financial resources, including *capital resources*) by holding the *capital resources* required by ■ GENPRU 2.1, the *appropriate regulator* may give the *firm individual capital guidance* advising it of the amount and quality of *capital resources* which the *appropriate regulator* considers it needs to hold in order to meet that *rule*.
- 7.1.95** G In giving *individual capital guidance*, the *appropriate regulator* seeks a balance between delivering consistent outcomes across the *individual capital guidance* it gives to all *firms* and recognising that such guidance should reflect the individual features of the *firm*. Comparison with the assumptions used by other *firms* will be used to trigger further enquiry. Debate will be sought where good arguments are made for a particular result that differs markedly from those of a *firm's* peers. The *appropriate regulator* also takes account of the quality of the wider risk management around the development of the numbers used in the *ICA*. The aim is to deliver *individual capital guidance* that comes closest to ensuring that there is no significant risk that a *firm* is unable to pay its liabilities as they fall due.
- 7.1.96** G Following an internal validation process, the *appropriate regulator* will write to the Board of the *firm* being assessed providing both quantitative and qualitative feedback on the results of the *appropriate regulator's* assessment. This letter will notify the *firm* of the *individual capital guidance* considered

appropriate. The letter will include reasons for any capital add-ons identified, where applicable.

- 7.1.97** G If a *firm* considers that the individual capital guidance is inappropriate to its circumstances, then the firm should inform the *appropriate regulator* that it does not intend to follow that *guidance*. Informing the *appropriate regulator* of such an intention would be expected if a *firm* is to comply with *Principle 11* (Relations with regulators).
- 7.1.98** G The *appropriate regulator* expects most disagreements about the adequacy of capital will be resolved through further analysis and discussion. The *appropriate regulator* may consider the use of its powers under section 166 of the Act (Reports by skilled persons) to assist in such circumstances. If the *appropriate regulator* and the *firm* still do not agree on an adequate level of capital, then the *appropriate regulator* may consider using its powers under section 55J of the Act to, on its own initiative, vary a *firm's Part 4A permission* so as to require it to hold capital in accordance with the *appropriate regulator's* view of the capital necessary to comply with ■ GENPRU 1.2.26 R. ■ SUP 7 provides further information about the *appropriate regulator's* powers under section 55J.
- 7.1.99** G Where a *firm* considers that the *capital resources requirements* of ■ GENPRU 2.1 require the holding of more capital than is needed for the *firm* to comply with ■ GENPRU 1.2.26 R then the firm may apply to the *appropriate regulator* for a *waiver* of the requirements in ■ GENPRU 2.1 under sections 138A and 138B of the Act. In addition to the statutory tests under sections 138A and 138B in deciding whether to grant a *waiver* and, if granted, its terms, the *appropriate regulator* will consider the thoroughness, objectivity and prudence of a *firm's ICA* and the extent to which the *guidance* in this section has been followed.

## Chapter 8

# General provisions applying INSPRU and GENPRU to Lloyd's



8.1 Application

8.1.1 R ■ INSPRU 8.1 applies to:

- (1) the *Society*;
- (2) *managing agents*.

8.1.2 R

8.1.3 G

8.1.4 R

8.1.5 G



8.2 Special provisions for Lloyd's

8.2.2 R

Management of risk

8.2.11 R

The *Society* must establish and maintain effective arrangements to monitor and manage risk arising from:

- (1) conflicts of interest (including in relation to (2) to (4));
- (2) inter-syndicate transactions, including *reinsurance to close* and *approved reinsurance to close*;
- (3) related party transactions; and
- (4) transactions between *members* and itself.

8.2.12 R

8.2.13 R

8.2.17 **R**

8.2.18 **R**

**Insurance receivables to be carried to trust funds**

8.2.19 **R**

The *Society* must take all reasonable steps to ensure that each *member*:

- (1) executes the appropriate *Lloyd's trust deeds*; and
- (2) carries to the appropriate *Lloyd's trust fund* all amounts received or receivable by the *member*, or on its behalf, in respect of any *insurance business* carried on by it.

8.2.20 **R**

The *Society* must carry all amounts it receives on behalf of any *member* in respect of that *member's insurance business* to the appropriate *Lloyd's trust fund*.

8.2.21 **R**

A *managing agent* must carry all amounts it receives on behalf of any *member* in respect of that *member's insurance business* to the appropriate *Lloyd's trust fund*.

8.2.22 **R**

In complying with ■ [INSPRU 8.2.19 R](#) to ■ [INSPRU 8.2.21 R](#), the *Society* and *managing agents* must take all reasonable steps to ensure that amounts received or receivable by a *member* in respect of *general insurance business* and *long-term insurance business* are carried to separate *Lloyd's trust funds*.

**Amendments to byelaws, trust deeds and standard form letters of credit and guarantees**

8.2.23 **R**

The *Society* must, as soon as it is practical to do so, notify the *appropriate regulator* of its intention to approve the form of any new *Lloyd's trust deed*.

8.2.24 **R**

The *Society* must, as soon as it is practical to do so, notify the *FCA* of its intention to make any amendment which may alter the meaning or effect of any *byelaw*, including:

- (1) any *Lloyd's trust deed*;
- (2) any standard form letter of credit prescribed by the *Society* from time to time; or
- (3) any standard form guarantee agreement prescribed by the *Society* from time to time.

8.2.25 **R**

The *Society* must provide the *FCA* with full details of:

- (1) the form of any new *Lloyd's trust deed* it intends to approve, as described in ■ [INSPRU 8.2.23 R](#) and
- (2) any amendments falling within ■ [INSPRU 8.2.24 R](#).

- 8
- 8.2.26

R

The *Society* must consult interested parties in relation to any new *Lloyd's trust deed* and in relation to any amendment falling within ■ INSPRU 8.2.24 R.
- 8.2.27

G

Except in urgent cases, the *Society* should consult in relation to any new *Lloyd's trust deed* or amendments before the new deed or amendments take effect.
- 8.2.28

R

The information provided to the *FCA* by the *Society* under ■ INSPRU 8.2.25 R must include:

(1) a statement of the purpose of any proposed amendment or new *Lloyd's trust deed* and the expected impact, if any, on *policyholders, managing agents, members, and potential members*; and

(2) a description of the consultation undertaken under ■ INSPRU 8.2.26 R including a summary of any significant responses to that consultation.
- 8.2.29

G

The *FCA* would normally expect to receive the information required under ■ INSPRU 8.2.25 R and ■ INSPRU 8.2.28 R not less than three months in advance of the proposed change.





8.4 Capacity Transfer Market

Application

8.4.1 R This section applies to the *Society*.

Purpose

8.4.2 G The *rules* and *guidance* in this section are intended to promote confidence in the market at Lloyd's, and to protect certain *consumers* of services provided by the *Society* in carrying on, or in connection with or for the purposes of, its *regulated activities*. They do this by ensuring that the *Society* appropriately and effectively regulates the *capacity transfer market* so that it operates in a fair and transparent manner.

Requirement to make byelaws governing conduct in the capacity transfer market

8.4.3 R The *Society* must make appropriate *byelaws* governing conduct in the *capacity transfer market*.

8.4.4 G The *byelaws* referred to in ■ INSURU 8.4.3 R should:

- (1) ensure that adequate and effective arrangements are in place to enable *members* and *persons* applying to be admitted as *members* to enter into transactions to transfer *syndicate* capacity and settle these transactions in a timely manner;
- (2) give clear and comprehensive guidance about the dissemination of information that is, or may be, relevant to the price of *syndicate* capacity and the transparency of the *capacity transfer market*; and
- (3) prohibit unfair and abusive practices (including market manipulation), the misuse of information not generally available, and the dissemination of false or misleading information.

8.4.5 G The *Society* should have adequate and effective arrangements to:

- (1) record and monitor transactions in the *capacity transfer market*, and maintain adequate audit trails; and
- (2) suspend or annul transactions where appropriate.

- 8.4.6** **G** The *Society* should regularly review the *byelaws* referred to in ■ **INSPRU 8.4.3 R**, taking account of the standards of conduct required in other *UK* financial markets.
- 8.4.7** **G** The *Society* should consult *members* and *underwriting agents* before it finalises material changes in the *byelaws* referred to in ■ **INSPRU 8.4.3 R**, and should have timely and effective arrangements for notifying them of changes in these *byelaws*.
- 8.4.8** **R**
- (1) The *Society* must give the *FCA* a report as at the end of each calendar quarter in which any capacity is transferred.
  - (2) The report referred to in (1) must reach the *FCA* within one month of the end of the relevant calendar quarter and must include information on:
    - (a) the total capacity in *syndicates* transferred during the quarter, analysed by *syndicate* and method of transfer;
    - (b) the number, and nature, of all investigations by the *Society* into conduct in the *capacity transfer market* undertaken or continued during the quarter; and
    - (c) the number, and nature, of all complaints received during the quarter about the operation of the *capacity transfer market*.

## Chapter 9

# Actions for damages



9.1      Actions for damages

9.1.1

**R**

A contravention of the *rules* in *INSPRU* does not give rise to a right of action by a *private person* under section 138D of the *Act* (and each of those *rules* is specified under Section 138D(3) of the *Act* as a provision giving rise to no such right of action).

## Insurance Prudential Sourcebook

### INSPRU TP Transitional provisions

Application		
1.1	R	<p><i>INSPRU</i> TP 1 applies to an insurer unless it is:</p> <ol style="list-style-type: none"> <li>(1) a <i>non-directive friendly society</i>; or</li> <li>(2) [deleted]</li> <li>(3) [deleted]</li> <li>(4) a <i>Solvency II firm</i>.</li> </ol>
<b>Version of IPRU to be used</b>		
1.2	R	Any reference in <i>INSPRU</i> TP to <i>IPRU(INS)</i> is to the version in force on 30 December 2004.
[FCA] [PRA]		
<b>Duration of transitional</b>		
1.3	R	<i>INSPRU</i> TP 1 applies until the relevant <i>rule</i> is revoked.
[FCA] [PRA]		
<b>Continuing effect of waivers</b>		
1.4	R	A <i>rule</i> in <i>INSPRU</i> listed in the Table at <i>INSPRU</i> TP Table 2 is disapplied, or is modified in its application, to a <i>firm</i> :
[FCA] [PRA]		
		<ol style="list-style-type: none"> <li>(1) in order to produce the same effect, including any conditions, as a <i>waiver</i> had on the corresponding <i>rule</i> in <i>IPRU(INS)</i>;</li> <li>(2) for the same period as the <i>waiver</i> would have lasted, if shorter than the period in <i>INSPRU</i> TP 1.3;</li> </ol> <p>provided the conditions set out in <i>INSPRU</i> TP 1.5 are satisfied.</p>
1.5	R	The conditions referred to in <i>INSPRU</i> TP 1.4 are:
[FCA] [PRA]		
		<ol style="list-style-type: none"> <li>(1) the <i>rule</i> is shown in the Table at <i>INSPRU</i> TP Table 2 as corresponding with the <i>rule</i> in <i>IPRU(INS)</i> in relation to which the <i>waiver</i> was granted to the <i>firm</i>;</li> <li>(2) the <i>waiver</i> was current as respects the <i>firm</i> immediately before 31 December 2004; and</li> <li>(3) there is no specific transitional <i>rule</i> relating to the <i>waiver</i>.</li> </ol>
1.6	R	[deleted]
1.7	R	A <i>firm</i> which has the benefit of a <i>waiver</i> to which <i>INSPRU</i> TP 1.4 applies must:
[FCA] [PRA]		
		<ol style="list-style-type: none"> <li>(1) notify the <i>appropriate regulator</i> immediately if it becomes aware of any matter which is material to the relevance or appropriateness of the <i>waiver</i>;</li> <li>(2) maintain a written record of the <i>rule</i> in <i>INSPRU</i> to which it considers the <i>waiver</i> applies; and</li> <li>(3) make the record available to the <i>appropriate regulator</i> on request.</li> </ol>

INSPRU TP Table 2

Rules in INSPRU	Corresponding rules in IPRU (INS)
2.1.22	4.14(1)
[PRA]	
3.1.34	5.11
[PRA]	
3.1.39	5.11
[PRA]	5.11(4)
	5.11(5)
	5.11(9)
	5.11(11)
3.1.58	2.3(2)
[FCA] [PRA]	
1.1.51	2.4(6)
[PRA]	
1.1.56	2.4(1)
[PRA]	
1.1.66	Appendix 2.1 2.4(1)(b)
[PRA]	Appendix 2.2 2.4(1)(b)
	5.9(1)
1.2.40	5.9(2)
[PRA]	
1.2.41	5.9(2)
[PRA]	
1.2.43	5.10
[PRA]	
1.2.74	[deleted]
6.1.17	10.1
[PRA]	10.2
	10.2(1)
	10.2(2)
	10.2(3)
6.1.23	10.2
[PRA]	10.2(1)
	10.2(2)
	10.2(3)

3	PRU waivers	
	<b>Application</b>	
3.1	R	<p><i>INSPRU</i> TP 3 applies to an <i>insurer</i> unless it is:</p> <ol style="list-style-type: none"> <li>(1) a <i>non-directive friendly society</i>; or</li> <li>(2) [deleted]</li> <li>(3) [deleted]</li> <li>(4) a <i>Solvency II firm</i>.</li> </ol>
	<b>Version of PRU to be used</b>	
3.2	R	A reference in <i>INSPRU</i> TP 3 to <i>PRU</i> is to the version in force on 30 December 2006.
[FCA] [PRA]		
	<b>Duration of transitional</b>	
3.3	R	<i>INSPRU</i> TP 3 applies until the relevant <i>INSPRU</i> rule is revoked.
[FCA] [PRA]		
	<b>Continuing effect of waivers</b>	
3.4	R	A rule in <i>INSPRU</i> is disapplied, or is modified in its application, to a <i>firm</i> :
[FCA] [PRA]		<ol style="list-style-type: none"> <li>(1) in order to produce the same effect, including any conditions, as a <i>waiver</i> had on the rule in <i>PRU</i>;</li> <li>(2) for the same period as the <i>waiver</i> would have lasted, if shorter than the period in <i>INSPRU</i> TP 3.3;</li> </ol> <p>provided the conditions set out in <i>INSPRU</i> TP 3.5 are satisfied.</p>
3.5	R	The conditions referred to in <i>INSPRU</i> TP 3.4 are:
[FCA] [PRA]		<ol style="list-style-type: none"> <li>(1) the rule in <i>PRU</i> in relation to which the <i>waiver</i> was granted to the <i>firm</i> was redesignated as the relevant rule in <i>INSPRU</i> by the Prudential Sourcebook for Insurers Instrument 2006;</li> <li>(2) the <i>waiver</i> was current as respects the <i>firm</i> immediately before 31 December 2006; and</li> <li>(3) there is no specific transitional rule relating to the <i>waiver</i>.</li> </ol>
3.6	R	[deleted]
3.7	R	A <i>firm</i> which has the benefit of a <i>waiver</i> to which <i>INSPRU</i> TP 3.4 applies must:
[FCA] [PRA]		<ol style="list-style-type: none"> <li>(1) notify the <i>appropriate regulator</i> immediately if it becomes aware of any matter which is material to the relevance or appropriateness of the <i>waiver</i>;</li> <li>(2) maintain a written record of the rule in <i>INSPRU</i> to which it considers the <i>waiver</i> applies; and</li> <li>(3) make the record available to the <i>appropriate regulator</i> on request.</li> </ol>
4	EEA pure reinsurers	
	[deleted]	
5	Pure reinsurance groups	
	[deleted]	
6	Admissible assets	
	[deleted]	

7	Mathematical reserves	
	Application	
7.1 [PRA]	R	INSPRU TP 7 applies to an <i>insurer</i> to which <a href="#">INSPRU 1.2</a> applies.
	Duration of transitional	
7.2 [PRA]	R	INSPRU TP 7 applies until the relevant <i>rule</i> is revoked.
7.3 [PRA]	R	<a href="#">INSPRU 1.2.79A R</a> does not apply in respect of <i>reinsurance</i> and analogous non- <i>reinsurance</i> financing agreements entered into and the terms of which came into effect before 10 December 2009, provided that immediately before 6 October 2010 the <i>firm</i> had the benefit of <a href="#">INSPRU 1.2.79 R (2)</a> in relation to those <i>reinsurance</i> or analogous non- <i>reinsurance</i> financing agreements.



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Schedule 1  
Record keeping requirements

Schedule 1.1 G

The aim of the *guidance* in the following table is to give the reader a quick overall view of the relevant record keeping requirements.

Schedule 1.2 G

It is not a complete statement of those requirements and should not be relied on as if it were.

Schedule 1.3 G

Table

Handbook reference	Subject of Record	Contents of Record	When record must be made	Retention Period
INSPRU 1.2.20 R [FCA] [PRA]	<i>Mathematical reserves</i>	(1) The methods and assumptions used in establishing the <i>firm's mathematical reserves</i> , including the margins for adverse deviation, and the reasons for their use (2) The nature of, reasons for, and effect of, any change in approach, including the amount by which the change in approach increases or decreases its <i>mathematical reserves</i>	Not specified	An appropriate period
INSPRU 1.5.23 R [FCA] [PRA]	<i>Long-term insurance funds</i>	A separate accounting record in respect of each of a <i>firm's</i>	Not specified	Not specified

Handbook reference	Subject of Record	Contents of Record	When record must be made	Retention Period
		<i>long-term insurance funds</i>		

# Insurance Prudential Sourcebook

## Schedule 2 Notification and reporting requirements

### Schedule 2.1 G

The aim of the *guidance* in the following table is to give the reader a quick overall view of the relevant notification requirements.

### Schedule 2.2 G

It is not a complete statement of those requirements and should not be relied on as if it were.

### Schedule 2.3 G

Table

Handbook reference	Matter to be notified	Contents of notification	Trigger event	Time allowed
[deleted]				
[deleted]				
[deleted]				
INSPRU 6.1.43B R	Intention of a <i>group undertaking</i> to issue a <i>capital instrument</i> for inclusion in <i>group capital resources</i>	Fact of intention and details of intended amount, issue date, type of investor, stage of capital, features of instrument and confirmation of compliance with <i>rules</i>	Intention to issue	As soon as proposed issue becomes known to <i>firm</i>
INSPRU 6.1.43C R	Proposed changes to details of the issue of a <i>capital instrument</i> notified under INSPRU 6.1.43B R	Proposed change and all information required under INSPRU 6.1.43B R (1) to INSPRU 6.1.43B R (4)	Intention to change any details of the issue previously notified to the <i>appropriate regulator</i>	As soon as the changes are proposed
INSPRU 6.1.43D R	Proposed establishment of a debt securities program by a <i>group undertaking</i>	All information required by INSPRU 6.1.43B R (1) to INSPRU 6.1.43B R (4)	Intention to establish	As soon as proposed establishment becomes known to <i>firm</i>
INSPRU 6.1.43F R	Issue of <i>capital instruments</i> by a <i>group under-</i>	All information required under INSPRU 6.1.43B R	Intention to issue	No later than date of issue

Handbook reference	Matter to be notified	Contents of notification	Trigger event	Time allowed
	<i>taking</i> under INSPRU 6.1.43E R	(1) to INSPRU 6.1.43B R (3) and confirmation that no changes have been made to the terms of the instrument since the previous issue of a similar instrument		
[deleted]				
[deleted]				
[deleted]				
INSPRU 8.2.23 R [FCA] [PRA]	Intention to approve the form of any new <i>Lloyd's trust deed</i>	Fact of intention	Intention to approve	As soon as practical
INSPRU 8.2.24 R [FCA] [PRA]	Intention to make any amendment which may alter the meaning or effect of any <i>byelaw</i> (including <i>Lloyd's trust deeds</i> , standard form letters of credit and guarantees)	Fact of intention	Intention to amend	As soon as practical
INSPRU 8.2.25 R [FCA] [PRA]	Full details of form of new <i>Lloyd's trust deed</i> or amendments to <i>byelaw</i> (including <i>Lloyd's trust deeds</i> , standard form letters of credit and guarantees)	(1) Statement of purpose of amendment or new form and expected impact, if any, on <i>policyholders</i> , <i>managing agents</i> , <i>members</i> and potential <i>members</i> , and (2) Description of the consultation undertaken and summary of significant responses to consultation	Not specified	Normally not less than three months in advance of proposed change

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## Insurance Prudential Sourcebook

### Schedule 3 Fees and other requirement payments

#### Sch 3 G

There are no requirements for fees or other payments in *INSPRU*.



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## Insurance Prudential Sourcebook

### Schedule 4 Powers exercised

**Schedule 4.1 G**  
[deleted]

**Schedule 4.2 G**  
[deleted]





Insurance Prudential Sourcebook

Schedule 5  
Rights of action for damages

Schedule 5.1 G

The table below sets out the *rules* in *INSPRU* contravention of which by an *authorised person* may be actionable under section 138D(2) of the *Act* (Actions for damages) by a *person* who suffers loss as a result of the contravention.

Schedule 5.2 G

If a "Yes" appears in the column headed "For *private person*", the *rule* may be actionable by a *private person* under section 138D(2) (or, in certain circumstances, his fiduciary or representative; see article 6(2) and (3)(c) of the Financial Services and Markets Act 2000 (Rights of Action) Regulations 2001 (SI 2001/2256)). A "Yes" in the column headed "Removed" indicates that the *FCA* has removed the right of action under section 138D(3) of the *Act*. If so, a reference to the *rule* in which it is removed is also given.

Schedule 5.3 G

The column headed "For other *person*" indicates whether the *rule* may be actionable by a *person* other than a *private person* (or his fiduciary or representative) under article 6(2) and (3) of those Regulations. If so, an indication of the type of *person* by whom the *rule* may be actionable is given.

Chapter/ Appendix	Section/Annex	Right of action under section 138D(2)		
		For <i>private person</i>	Removed	For other <i>person</i>
All <i>rules</i> in <i>INSPRU</i>		No	Yes (INSPRU 9.1.1R)	No



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## Insurance Prudential Sourcebook

### Schedule 6 Rules that can be waived

#### Sch 6 G

The rules in *INSPRU* can be waived by the *appropriate regulator* under sections 138A and 138B of the *Act* (Modification or waiver of rules), except for ■ [INSPRU 9.1.1 R](#) (Actions for damages).

