Chapter 1

Capital resources requirements and technical provisions for insurance business

1.5 Internal-contagion risk

Application

1.5.1 R 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*.

[1.5.2 to 1.5.3 not used]

1.5.4 R In 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.

1.5.5A R In 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*.

1.5.7 G The requirements of this section apply to a *firm* on a solo basis.

Purpose

1.5.8 G This section sets out requirements for a *firm* 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 *firm*. It may also arise from the combination of activities within the same *group*, 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 *firm* carries on:

(1) both insurance and non-insurance activities; or

(2) two or more different types of insurance activity; or

(3) insurance activities from offices or *branches* located in both the *United Kingdom* and overseas.

1.5.10 G This section requires *firms* other than *pure reinsurers* to limit non-insurance activities to those that directly arise from their *insurance business*, e.g. investing assets, employing insurance staff etc. It also requires that an adequate provision be established for non-insurance liabilities. *pure reinsurers* must limit their activities to the business of *reinsurance* and related operations.

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 *firm* 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 *policyholders*. They apply where a *firm* carries on both:

(1) general insurance business and *long-term insurance business*;

(2) linked and non-linked *insurance business*.

1.5.12 G Finally, the section sets out requirements to protect *policyholders* of the *United Kingdom branches* of *firms* with their head office outside the *United Kingdom*.

Restriction of business

Requirements: Non-insurance activities

1.5.13 R (1) A *firm* other than a *pure reinsurer* must not carry on any commercial business other than *insurance business* and activities directly arising from that business.

(2) (1) does not prevent a *friendly society* which was on 15 March 1979 carrying on *long-term insurance business* from continuing to carry on savings business.

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 usingan 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.

1.5.37 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*.

Application of INSPRU 1.5 to Lloyd's

1.5.58 R

1.5.59 R