FSA 2002/33

INTERIM PRUDENTIAL SOURCEBOOK FOR INSURERS (IMPLICIT ITEMS AND RESILIENCE TEST) INSTRUMENT 2002

Powers exercised

A. The Financial Services Authority amends the Interim Prudential sourcebook for insurers in the exercise of the power in section 157(1) of the Financial Services and Markets Act 2000 (Guidance).

Commencement

B. This instrument comes into force on 1 June 2002.

Amendment of the Interim Prudential sourcebook for insurers

C. IPRU(INS) is amended in accordance with the Annex to this instrument.

Citation

D. This instrument may be cited as the Interim Prudential Sourcebook for Insurers (Implicit Items and Resilience Test) Instrument 2002.

By order of the Board
16 May 2002

ANNEX

Amendments to IPRU(INS)

In this Annex, underlining indicates new text and striking through indicates deleted text.

FSA Guidance Notes
Guidance Note 4.1

Guidance for insurers and auditors on the Valuation of Assets Rules

4. Valuation Rules

…

~~**Implicit items: future profits**~~

~~4.92 (1) *Insurers* may apply for a waiver from rule 2.10 so that the *implicit item* relating to future profits may be valued at not more than 50% of the full amount of future profits.~~

~~(2) For the purposes of (1), the full amount of future profits is the estimated annual profit multiplied by a factor which, as closely as possible, represents the average number of years remaining to run on *policies,* but does not exceed 10.~~

~~(3) For the purposes of (2) -~~

~~(a) the estimated annual profit is one-fifth of the profits made in *long-term insurance business* over a period of five years (the **relevant period**) ending on the last day of the most recent *financial year* for which a valuation under rule 9.4 has been carried out, substantial items of an exceptional nature being excluded; and~~

~~(b) the average number of years remaining to run on *policies* is calculated -~~

~~(i) by multiplying the number of years to run on each *policy* by the actuarial value of the benefits payable under the *policy*, adding together the products so obtained and dividing the total by the aggregate of the actuarial values of the benefits payable under all the *policies*, or~~

~~(ii) by an approximation to this method of calculation suitable to the circumstances of the case, including, where appropriate, an approximation involving the grouping of contracts,~~

appropriate allowance being made in either case for premature termination of contracts.

(4) For the purposes of (3)(a) -

(a) where a valuation under rule 9.4 has been carried out annually in relation to the 'relevant period', the profits made in *long-term insurance business* for any particular year of the 'relevant period' is the surplus (if any) arising in the *long-term insurance fund* since the last such valuation, and the profit so made for that period is the aggregate of those surpluses less any deficiencies in the *long-term insurance fund* during that period;

(b) where an *insurer* has carried on *long-term insurance business* throughout the 'relevant period' but valuations under rule 9.4 have not been made annually in that period, the profits so made for that period are the aggregate of surpluses arising in the *long-term insurance fund* since the last valuation preceding the 'relevant period' less any deficiencies in the *long-term insurance fund* since that last valuation, except that the surplus or deficiency arising in the period ending with the first valuation within the 'relevant period' is proportionately reduced to allow for any period of time falling outside the relevant period; and

(c) where an *insurer* has not carried on *long-term insurance business* throughout the 'relevant period', the profits made *in long-term insurance business* for the 'relevant period' are the aggregate of any surpluses arising in the *long-term insurance fund* during that part of the 'relevant period' for which *long-term insurance business* was carried on less any deficiencies in the *long-term insurance fund* during that part of that period.

Implicit items: zillmerising

4.93 (1) *Insurers* may apply for a waiver from rule 2.10 so that, where *zillmerising* is appropriate, but either is not practised or is at a rate less than the loading for acquisition costs included in the premium, then, subject to (6), the *implicit item* relating to *zillmerising* may be valued at an amount not exceeding the difference between -

(a) the *non-zillmerised* or partially *zillmerised* figure *for mathematical reserves* maintained by the *insurer*; and

(b) a figure for *mathematical reserves* (not less than those required by the *Determination of Liabilities Rules*)

~~*zillmerised* at a rate equal to the loading for acquisition costs included or allowed for in the premium.~~

~~(2) Where *zillmerising* is not practised, then, subject to (6), the value given by (1) (less any amount relating to temporary assurances) may not exceed 3.5% of the aggregate of the difference between -~~

~~(a) the 'relevant capital sums' for *long-term insurance business* activities; and~~

~~(b) the *mathematical reserves* (excluding *mathematical reserves* for temporary assurances).~~

~~(3) Where *zillmerising* is practised but is at a rate less than the loading for acquisition costs, then, subject to (6), the value given by (1) (less any amount relating to temporary assurances) together with the difference between the partially *zillmerised mathematical reserves* and the *non-zillmerised mathematical reserves* may not exceed 3.5% of the aggregate of the difference between -~~

~~(a) the 'relevant capital sums' of *long-term insurance business* activities; and~~

~~(b) the *mathematical reserves* (excluding *mathematical reserves* for temporary assurances).~~

~~(4) In (2) and (3), **relevant capital sums** means -~~

~~(a) for whole life assurances, the sum assured;~~

~~(b) for *policies* where a sum is payable on maturity (including *policies* where a sum is also payable on earlier death), the sum payable on maturity;~~

~~(c) for deferred annuities, the capitalised value of the annuity at the vesting date (or the cash option if it is greater);~~

~~(d) for capital redemption contracts, the sums payable at the end of the contract period; and~~

~~(e) for *linked long-term contracts*, notwithstanding (a) to (d), the lesser of -~~

~~(i) the amount for the time being payable on death, and~~

~~(ii) the aggregate of the value for the time being of the units allocated to the contract (or, where entitlement is not denoted by means of units, the value for the time being of any other measure of entitlement under the contract equivalent to units) and the total amount of the premiums remaining to be paid during such of the term of the contract as is appropriate for *zillmerising* or, if such premiums are payable beyond the age of seventy-five, until that age,~~

~~excluding in all cases any vested reversionary bonus and any capital sums for temporary assurances.~~

~~(5) Where, under the contract relating to any such business as is mentioned in (4), the payment of premiums is to stop before the sum assured becomes due, then, notwithstanding (4), **relevant capital sums** in (1) to (3) means the *mathematical reserves* appropriate for that contract at the end of the premium-paying term.~~

~~(6) For the purposes of this guidance –~~

~~(a) reserves for vested reversionary bonuses will not be regarded as *mathematical reserves*; and~~

~~(b) the result given by (1), (2) or (3) will be reduced by the amount of any undepreciated acquisition costs brought into account as an asset.~~

~~**Implicit items: hidden reserves**~~

~~4.94 *Insurers* may apply for a waiver of rule 2.10 so that the *implicit item* relating to hidden reserves, if it consists of hidden reserves resulting from the underestimation of assets and overestimation of liabilities (other than *mathematical reserves*), may, in so far as the hidden reserves in question are not of an exceptional nature, be given its full value.~~

<u>[paragraphs 4.92 to 4.94 deleted]</u>

After Guidance Note 2.1 insert the following:

“Guidance Note 2.2

GUIDANCE ON APPLICATIONS FOR WAIVERS RELATING TO IMPLICIT ITEMS

Implicit items under the Act

1. Rule 2.10(5) of *IPRU(INS)* and rule 4.7(3) of *IPRU(FSOC)* do not permit *implicit items* to count towards solvency. However, the *First Life Directive* states that *implicit items* can count towards solvency, within limits, providing that the supervisory

authority agrees. Accordingly, the *FSA* may be prepared to grant a waiver from rule 2.10(5) of *IPRU(INS)* or rule 4.7(3) of *IPRU(FSOC)* to allow *implicit items*, in line with the purpose of the Directive, and provided the Directive conditions are met.

2. The Financial Services and Markets Act 2000 (the "Act") applies from 1 December 2001. Under section 148 of the *Act*, the *FSA* may, on the application of an *insurer* or *friendly society*, grant a waiver from *IPRU(INS)* or *IPRU(FSOC)*. There are general requirements that must be met before any waiver can be granted. As explained in *SUP 8*, the *FSA* may not give a waiver unless it is satisfied that:

   (1) compliance by the *firm* with the rule will be unduly burdensome, or would not achieve the purpose for which the rules were made; and

   (2) the waiver would not result in undue risk to persons whose interests the rules are intended to protect.

3. Compliance with the requirements will be assessed by the *FSA* in the light of all the relevant circumstances. This will include consideration of the costs incurred by compliance with a particular rule or whether a rule is framed in a way that would make compliance difficult in view of the *firm's* circumstances. For example, the *firm* may demonstrate that if an *implicit item* were not allowed the *firm* would either have to suffer increased (and unwarranted) costs in injecting further capital or operate with a lower equity backing ratio (see case studies in paragraph 42).

4. *Implicit items* are economic reserves which are hidden within the *long-term insurance business* provisions. Rule 2.10(5) of *IPRU(INS)* identifies three types of *implicit item*: future profits, *zillmerisation* and hidden reserves. This note is intended to give guidance on factors in addition to the general requirements of *SUP* 8 relating to the granting of waivers for *implicit items*.

Solvency I Directive

5. The proposed Solvency I Directive was published by the EU Commission in October 2000 and a final directive has now been adopted (Directive 2002/12/EC of 5 March 2002, OJ L 77/11, 20.3.2002). This directive requires member states to end a *firm's* ability to take into account future profits *implicit items* by (at the latest) 31 December 2009. Until then, from a time to be established by member states under transitional provisions in the directive, the maximum amount of these economic reserves that can count will be limited to 25% of the lesser of the available solvency margin and the required solvency margin, and the 'average period to run' will be limited to 6 years. This guidance does not anticipate the new limits. The *FSA* will consult on the implementation of new limits in due course. However, waivers will typically only be granted for a maximum of 12 months and *firms* will need to consider the potential impact of these future changes when engaging in future capital planning.

Future profits

6. The future profits implicit item allows *insurers* to take credit for margins in the *mathematical reserves* to the extent that these are expected to emerge from in force business. The future profit from in force business should be assessed, in the first instance, on prudent assumptions, to demonstrate that there is an 'economic reserve'.

Having demonstrated that it exists, the amount should be limited to an amount calculated using a formula that takes into account the actual profit which has emerged over the last five years (see paragraph 19).

Zillmerisation

7. *Zillmerisation* is an allowance for acquisition costs that are expected, under prudent assumptions, to be recoverable from future premiums. *Insurers* can make a direct adjustment to their reserves for *zillmerisation*, subject to the rules on *mathematical reserves*. However, where no such adjustment has been made, the *FSA* will consider an application for a waiver to take into account an *implicit item*.

Hidden reserves

8. Hidden reserves are reserves resulting from the underestimation of assets and overestimation of liabilities (other than *mathematical reserves*).

Process for applying for a waiver, including limits applicable when a waiver is granted

9. This section sets out the procedures to be followed and the form of calculations and data which should be submitted by *firm*s to the *FSA*. This guidance should also be read in conjunction with the general requirements relating to the waiver process described in *SUP* 8. The *FSA* expects that applications for waivers in respect of future profits and *zillmerising* will not normally be considered to pass the "not result in undue risk to persons whose interests the rules are intended to protect" test unless the relevant criteria set out in this guidance have been satisfied. As set out below, waivers in respect of hidden reserves will not normally be given except in very exceptional circumstances.

Timing

10. A *long-term insurer* may apply to the *FSA* for a waiver in respect of *implicit items*. A waiver will not apply retrospectively (see *SUP* 8.3.6G). Consequently, applications intended for a particular accounting reference date will normally need to be made well before that reference date. Applications by *insurers* must be made in writing to the *FSA* and include the relevant details specified under *SUP* 8.3.2D. Given the uncertainty in predicting the future, waivers will normally be granted for a maximum of 12 months at a time and any further applications will need to be made accordingly.

11. The information that will be required to enable an application to be considered, set out below, should normally include a demonstration of how the *required solvency margin* is to be met, with and without the waiver. Clearly, up-to-date information may not be available before the *financial year*-end. In some cases information from the previous year-end's *return* may be used, as long as any known significant changes in the structure of the *insurer*, or the assumptions used, have been taken into account.

12. If the application for a waiver is granted, when an *insurer* submits its *return* the amount of the *implicit item* shown should not exceed that supported by the *insurer's* calculations **as at the valuation date**. In the event that the amount of the future profits item calculated by the *appointed actuary* based on these updated assumptions is less

than the amount calculated at the time of the *insurer's* waiver application, the lower figure should be used in the *return*.

13. An *implicit item* in respect of *zillmerising* or hidden reserves is related to the basis on which liabilities or assets have been valued. In the case of hidden reserves, as explained below, the granting of a waiver will be dependent on the overall solvency position of the *insurer*. Waivers in respect of these *implicit items* will, therefore, only be made in relation to the position shown in a particular set of *returns* and it will be essential for *insurers* to submit applications to the *FSA* well in advance of the latest date for the submission of the relevant *return*.

14. Waivers cannot be back-dated and may be withdrawn by the *FSA* at any time (e.g. where the *FSA* considers the amount in respect of which a waiver has been given can no longer be justified). This may be as a result of changes in the *insurer's* position or as a result of queries arising on scrutiny of the *returns*.

Information to be submitted

15. An application to the *FSA* for a waiver should state clearly the nature and the amounts of the *implicit items* that an *insurer* wishes to count against its *required margin of solvency*. The application should be accompanied by full supporting information to enable the *FSA* to arrive at a decision on the merits of the case. In particular, the application should demonstrate that in allowing for *implicit items* there has been no double counting of future margins and that the basis for valuing such margins is prudent.

16. The *FSA* recognises that the assessment of the insurance *technical provisions* reflects the contractual obligations of the *insurer*. *Implicit items* are therefore "fat" in these *technical provisions* only. Non-contractual "constructive" obligations such as *policy holders'* reasonable expectations as to future terminal bonuses are not fully captured by the *technical provisions*. The *appointed actuary* must instead be satisfied that the *insurer* has sufficient resources at all times to meet "reasonable bonus expectations" (see *SUP* 4.3.13R). The granting of a waiver for an *implicit item* does not in any way detract from this requirement and the *appointed actuary* will need to be satisfied that this condition is still met.

17. Applications for a waiver in respect of a hidden reserves *implicit item* will normally be considered only if accompanied by the information which is contained in the annual regulatory *returns*. In particular, the balance sheet forms, *long-term insurance business* revenue accounts, and abstract valuation report of the actuary as set out in **Appendices 9.1**, **9.3** and **9.4** of *IPRU(INS)* should be provided. As a minimum, applications for a future profits *implicit item* should be supported by the information contained in **Forms 13**, **14**, **40**, **41**, **42**, **48**, **49**, the answers to questions 1 to 12 of the abstract valuation report, **Appendix 9.4** of *IPRU(INS)* and **Forms 51**, **52**, **53**, **54** and **58**. For a *zillmerisation implicit item,* only those items noted above forming part of the abstract valuation report will normally be needed. This is not to say that a full regulatory *return* must be provided in the specified format, simply that the information contained in these forms should be provided. Where appropriate, the information may be summarised.

18. In addition, the following information relating to the calculation of the amounts claimed should be supplied:

- Future profits: the profits reported in each of the last five *financial years* up to the date of the most recent available valuation under rule 9.4 of *IPRU(INS)* which has been submitted to the *FSA* prior to, or together with, the application, and the amounts and nature of any exceptional items left out of account; the method used for calculating the average period to run and the results for each of the main categories of business, both before and after allowing for premature termination (where the calculation has been made in two stages); and the basis on which this allowance has been made.

- *Zillmerising*: the categories of contracts for which an item has been calculated and the percentages of the relevant capital sum in respect of which an adjustment has been made.

- Hidden reserves: particulars, with supporting evidence, of the undervaluation of assets or the overvaluation of liabilities (other than *mathematical reserves*) for which recognition is sought.

Continuous monitoring by firms

19. *Firms*, advised by their *appointed actuaries*, should take into account any material changes in financial conditions or other relevant circumstances that may have an impact on the level of future profits that can prudently be taken into account e.g. change in valuation assumptions due to higher equity yield assumptions from 1 December 2001 (see *IPRU(INS)* rule 5.11(5)). *Firms* and their *appointed actuaries* should also re-evaluate whether an application to vary an *implicit item* waiver should be made whenever circumstances have changed. In the event that circumstances have changed such that an amendment is appropriate, the *firm* should contact the *FSA* as quickly as possible (see *SUP* 8.5.1R). Principle 11 of the Principles for Businesses requires *firm*s to disclose anything of which the *FSA* would reasonably expect notice. In this context the *FSA* would expect notice of any matter that materially impacts on the *firm's* financial condition, or any waivers granted.

Future profits - factors to take into account when submitting calculations to support waiver applications

20. Where an application is made in respect of an *insurer* which has separate with-profit and non-profit funds, the *insurer* should ensure that the *required minimum margin* in respect of the non-profit fund is not covered by future profits attributable to *policy holders* arising in the *with-profits fund*.

21. *Firms* need to assess prospective future profit (i.e. how much can reasonably be expected to arise) and compare this to maximum limits (in the *First Life Directive*), which relate to past profits.

Future profits - prospective calculation

22. The application for a waiver should be supported by details of a prospective calculation of future profits arising from in-force business. The information supplied to the *FSA* should include a description of the method used in the calculation and of the assumptions made, together with the results arising.

Assumptions

23. The assumptions made should be prudent, rather than best estimate, assumptions of future experience (i.e. the prudent assumptions should allow for the fair market price for assuming that risk). In particular, it would not normally be considered appropriate for the projected return on any asset to be taken to be higher than the risk-free yield (i.e. assessed by reference to the yield on suitable government stocks). Furthermore, it may be appropriate to bring future withdrawals into account on a suitably prudent basis. For with-profits business, the assumptions for future investment returns should not capitalise future bonus loadings except where the with-profits *policy holders* share in risks other than the investment performance of the fund. Furthermore, the rate at which future profits are discounted should include an appropriate margin over a risk free rate of return. Calculations should also be carried out to demonstrate that the financial position of the *insurer* is resilient to the same changes in financial conditions assumed for the resilience test of the *mathematical reserves*.

Other charges to future profits

24. To avoid double counting, no account should be taken of any future surplus arising from assets corresponding to explicit items which have been counted towards the *required solvency margin* such as shareholders funds, surplus carried forward or investment reserves. Deductions should be made in the calculation of future surpluses for the impact of any other arrangements which give rise to a charge over future surplus emerging (e.g. financial reinsurance arrangements, subordinated loan capital or contingent loan agreements). The information supplied to the *FSA* should identify the amount and reason for any adjustments made to the calculation of the prospective amount of future profits.

25. The *appointed actuary* should confirm to the *FSA* that the calculations have been properly carried out and that there are no other factors that should be taken into account.

Future profits - retrospective calculation

Overriding limit

26. The maximum amount of the *implicit item* relating to future profits permitted under the *First Life Directive* is 50% of the product of the estimated annual profit and the average period to run (not exceeding 10 years) on the *policies* in the portfolio. The *FSA* will not therefore allow more than this.

Definition of profits

27. The estimated annual profit should be taken as the average annual surplus arising in the *long-term insurance fund* (including the change in any investment reserve) over the last five *financial years* up to the date of the most recent available valuation under rule 9.4 of *IPRU(INS)* which has been submitted to the *FSA* prior to, or together with, the application. For this purpose, deficiencies arising should be treated as negative surpluses. Where a *firm's financial year* has altered, the surplus arising in a period falling partly outside the relevant five year period should be assumed to accrue uniformly over the period in question for the purpose of estimating the profits arising

within the five year period. When there has been a transfer of a block of business into the *firm* (or out of the *firm*) during the period, the impact of the transfer will need to be taken into account to reflect the remaining portfolio.

28. Where a *firm* has been carrying on *long-term insurance business* for less than 5 years, the total profits made during the past 5 years should be taken to be the aggregate of any surpluses that have arisen during the period in which *long-term insurance business* has been carried on less any deficiencies that may have arisen during that period. The resulting total should still be divided by five to obtain the estimated annual profit.

Exceptional items

29. Substantial items of an exceptional nature should be excluded from the calculation of the estimated annual profit. Such items include profits arising from an exceptional change in the value at which assets are brought into account, where this is not reflected in a similar change in the amount of the liabilities, and profits arising from a change in the overall valuation approach between one year and another. An exceptional loss (i.e. a reduction of an exceptional nature in the surplus arising) may be excluded from the calculation only to the extent that it can be set against a profit or profits up to the amount of the loss and arising from a similar cause. It is not intended, however, that any adjustment should be made for the effect on surplus of a net strengthening of reserves for costs associated with an expansion of the business or for special capital expenditure, such as the purchase of computer systems.

Double counting

30. The inclusion of investment income arising from the assets representing the explicit components of the solvency margin (as part of the estimated annual profit for the purpose of determining the future profits *implicit item*) would result in double counting. If those assets were required to meet the effects of adverse developments, this would automatically result in the cessation of the contribution to profits from the associated investment income. It would clearly not be appropriate for the *FSA* to grant a waiver which would enable a *firm* to meet the *required solvency margin* on the basis of counting both the capital values of the assets and the value of the income flow which they can be expected to generate.

31. The definition of the estimated annual profit as the surplus arising in the *long-term insurance fund* ensures that any contribution to surplus arising from transfers from the profit and loss account, including investment income on shareholders' assets, is not included in the estimated annual profit. Thus double-counting should not arise in respect of shareholders' assets. Double-counting may arise, however, in respect of the investment income from the assets representing the explicit components of the solvency margin carried within the *long-term insurance fund* (e.g. surplus carried forward or investment reserves), but the amount of such investment income is not separately identified in the *return*.

32. Where there is reason to suspect that the elimination of any such double-counting would reduce a *firm's* solvency margin to close to or below the required level, or would otherwise be significant, the *FSA* will request this information with a view to taking account of this factor in determining the amount of the *implicit item*. Additional information concerning investment income should be furnished with an application for

a waiver, if a *firm* believes that any double-counting would fall into one of the categories mentioned above.

Average period to run

33. The average number of years remaining to run on *policies* should be calculated on the basis of the weighted average of the periods for individual *contracts of insurance*, using as weights the actuarial present value of the benefits payable under the contracts. A separate weighted average should be calculated for each of the various categories of contract and the results combined to obtain the weighted average for the portfolio as a whole. Approximate methods of calculation, which the *appointed actuary* considers will give results similar to the full calculation, will be accepted. In particular, the *FSA* will normally accept the calculation of an average period to run for a specific category of contract on the basis of the average valuation factor for future benefits derived from data contained in the *appointed actuary's* report in the regulatory *returns*. A *firm* will be asked to demonstrate the validity of the method adopted only where an abnormal distribution of the business in force gives grounds for doubt about its accuracy.

34. Calculations will normally be requested only for the main categories of *insurance business*, accounting for not less than 90% of the *mathematical reserves*, except where there are grounds for expecting that the exclusion of certain categories of *policies* under this provision might have a significant effect on the resulting average period to run. Detailed calculations will not be required where a waiver is sought in respect of a low multiple of the annual profits, well within the average period to run for the *firm*.

35. Where, for a particular category of business, a method of valuation is used which does not involve the calculation of the value of future benefits and which is significant for the *firm* in question, the calculation of the average period to run should be based on estimates of the value of future benefits. For non-linked benefits, these estimates would normally be available from the demonstration required under paragraph 8(d) of **Appendix 9.4** of *IPRU(INS)* – that the reserves are not less than those obtained on the basis of a net premium valuation; otherwise special estimates of the value of future benefits may have to be made specifically for the purpose of the application. In the case of regular premium unit *linked contracts*, where the method of valuation does not involve estimating the value of benefits to be purchased by further premiums, the value of benefits should be taken to be the reserves currently held (unit and non-unit liabilities) together with the present value of the portions of future premiums which are to be invested in units under the terms of the contracts.

Premature termination of contracts

36. Allowance should be made for the premature termination of *contracts of insurance*, based on the actual experience of the *insurer* over the last five years, or other appropriate period, and taking into account specific features of contracts such as options which can be expected to lead to premature termination (e.g. guaranteed surrender values on income bonds written as *long-term insurance contracts* and option dates on flexible whole-life contracts). The adjustment should be made separately for each of the main categories of business. The use of industry-wide rates of termination will be acceptable where the *appointed actuary* is satisfied that this will result in sufficient allowance being made having regard to the *insurer's* own experience. Methods of calculation that involve a degree of approximation will be permitted.

37. For certain types of contract, where the period left to run is most naturally defined as the term to a fixed maturity or expiry date, the allowance for premature termination should also take into account terminations resulting from death.

Overall limit

38. The overall average period left to run calculated as described above should be limited to a maximum of ten years before applying it to the estimated annual profit in order to determine the maximum value of the future profits *implicit item*.

Definition of period to run

39. The definition of the period to run and the basis of the allowance for early termination should clearly be considered together. For certain types of contracts (e.g. pension contracts with a range of retirement ages or other options), there is inherent uncertainty about the likely term to run. In such circumstances any estimate for determining the amount of the future profits *implicit item* for which a waiver is sought should be based on prudent assumptions tending, if anything, to underestimate the average period to run.

Zillmerising

40. The *FSA* does not normally expect to grant waivers permitting *implicit items* due to *zillmerisation* except in very exceptional circumstances. *Zillmerisation* is an allowance for acquisition costs that are expected, under prudent assumptions, to be recoverable from future premiums. *Firms* can make a direct adjustment to their reserves for *zillmerisation*, subject to the requirements on *mathematical reserves* set out in rule 5.10 of *IPRU(INS)*, and this is the usual approach. However, where no such adjustment has been made, or where the maximum adjustment has not been made in the *mathematical reserves*, the *FSA* will consider an application for an *implicit item*, if the amount is consistent with the amount that would have been allowed as an adjustment to *mathematical reserves* under rule 5.10 of *IPRU(INS)*.

Hidden reserves

41. The *FSA* will grant waivers permitting *implicit items* due to hidden reserves only in very exceptional circumstances. These items relate to hidden reserves resulting from the underestimation of assets and overestimation of liabilities (other than *mathematical reserves*). The *Valuation of Assets Rules* and *Determination of Liabilities Rules* which apply to assets and liabilities other than *mathematical reserves* are based on current value with adjustments for regulatory prudence such as concentration limits for large holdings, and would not normally be expected to contain hidden reserves.

Case studies on "unduly burdensome"

42. Some examples of situations where the existing rules might be considered to be unduly burdensome are given below:-

    - A *firm* writes with-profit business. The *firm's* investment policy is affected by its published financial position. Application of the rules without an *implicit item* would result in the *firm* adopting a lower equity backing ratio. It may be possible to

demonstrate that, in the circumstances, it would be unduly burdensome to require the *firm* to incur costs (which might prejudice policyholders) resulting from the lower equity backing ratio, rather than take allowance for an *implicit item*.

- A *firm* has purchased a block of in-force business, on which the future profits may be reasonably estimated. However, this asset is given no value under the rules. It may be possible to demonstrate that it is unduly burdensome for the *firm* to recognise the cost of acquiring the assets whilst giving no value to the asset acquired.

- A *firm* has a block of in-force business, on which the future profits may be reasonably estimated. Application of the rules without an *implicit item* would result in a need to obtain additional capital. It may be possible to demonstrate that it is unduly burdensome, having regard to the particular circumstances of the *firm*, to require it to incur the costs involved in the injection of further capital rather than take allowance for an *implicit item*.

- A *firm* has purchased matching assets for guaranteed annuity liabilities. The operation of the asset and liability valuation rules leads to statutory losses in certain circumstances in spite of good matching of assets and liabilities on a realistic basis of assessment. It may be possible to demonstrate that it is unduly burdensome to require the *firm* to incur the costs involved in the injection of further capital rather than take allowance for an *implicit item*.

Conditions which will typically be applied to implicit items waivers

Limits

43. Where *implicit items* waivers are granted, the value cannot exceed (and will normally be less than) the monetary limits described in paragraph 26. In addition, time limits will apply and waivers will normally only last for 12 months.

Publicity

44. The waiver will be published by the *FSA* (see *SUP* 8.7). Public disclosure is standard practice unless the *FSA* is satisfied that publication is inappropriate or unnecessary (see section 148 of the *Act*). Any request that a direction not be published should be made to the *FSA* in writing with grounds in support, as set out in *SUP* 8.6.

45. Disclosure of a waiver will normally be required in the *firm's* annual *returns*."

After Guidance Note 4.4 insert the following.

"Guidance Note 5.1

RESILIENCE TEST

1. The resilience test is a requirement for prudent provision to be made against the effects of possible future changes in the value of assets on the adequacy of these assets to meet liabilities. This requirement is in rule 5.17 of *IPRU(INS)*.

2. *Firms* should, as a minimum, consider the scenario of a fall in the *market value* of equities of the greater of:

   (1) 25%, or such lower amount which would not produce a P/E ratio on the FTSE Actuaries All Share Index lower than 75% of the inverse of the long-term gilt yield (as defined in rule 5.11(9) of *IPRU(INS)*); and

   (2) 10%.

3. At the same time, *firms* should make the assumption that the earnings yield on equities will fall by 10% (shortly after the above fall in equity values), but that dividends would remain unaltered when assessing the corresponding rate of interest at which the liabilities should be valued.

4. The *appointed actuary*, in advising the *firm*, would then be expected to apply his or her own professional judgement in considering the level of changes in the *market value* of, and yield on, other types of investment held by the *firm* for the purpose of this resilience test. The prudence concept should be paramount. Reductions in fixed interest yields, or changes in the shape of the yield curve, are among the obvious possibilities.

5. The *firm* should also take account of the nature of the assets and liabilities. For example, a *firm* which has only unit linked business, some of which carries a guaranteed annuity rate, should not necessarily assume that equity values fall in applying tests for lower fixed interest rates. Indeed *firms* should consider their resilience to a rise in equity values combined with falling interest rates.

6. The *FSA* also expects that *firms* will continue to investigate a wide range of possible future investment scenarios for the purpose of their own stress testing and risk management."