PRUDENTIAL REQUIREMENTS FOR INSURERS (AMENDMENT) INSTRUMENT 2006

Powers exercised
A. The Financial Services Authority makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 ("the Act"):  
   (1) section 138 (General rule-making power);  
   (2) section 150(2) (Actions for damages);  
   (3) section 156 (General supplementary powers); and  
   (4) section 157(1) (Guidance).

B. The rule-making powers listed above are specified for the purpose of section 153(2) (Rule-making instruments) of the Act.

Commencement
C. This instrument comes into force as follows:  
   (1) The amendments in Annex A to the Glossary of definitions come into force on 31 December 2006.  
   (2) The remainder of this instrument comes into force on 30 December 2006.

Amendments to the Handbook
D. The Glossary of definitions is amended in accordance with Annex A to this instrument.

Amendments to FSA Instruments
E. Annex B (Chapters 1 and 2 of GENPRU) to the General Prudential Sourcebook Instrument 2006 (FSA 2006/40) is amended in accordance with Annex B to this instrument.

F. Annex B (Text of INSPRU) to the Prudential Sourcebook for Insurers Instrument 2006 (FSA 2006/42) is amended:  
   (1) by substituting for INSPRU 7.1 the version of INSPRU 7.1 set out in Annex C to this instrument;  
   (2) by deleting INSPRU 7 Annex 1G; and  
   (3) otherwise in accordance with Annex D to this instrument.
The General Prudential Sourcebook (Transitional Provisions and Schedules) Instrument 2006 (FSA 2006/51) is amended as follows:

(1) Paragraph C (Commencement) is amended by substituting for sub-paragraph (1) the following:

"(1) The following provisions of the General Prudential Sourcebook (GENPRU) come into force on 31 December 2006:

(a) GENPRU TP 1 to GENPRU TP 6, GENPRU TP 10 to GENPRU TP 13 and GENPRU TP 15;
(b) Schedules 1 to 6 to GENPRU."; and

(2) Annex A (Chapter TP of GENPRU and GENPRU Schedules) is amended in accordance with Annex E to this instrument.

Annex A (Amendments to the Glossary) to the CRD (Consequential Amendments) Instrument 2006 (FSA 2006/53) is amended in accordance with Annex F to this instrument.

This instrument may be cited as the Prudential Requirements for Insurers (Amendment) Instrument 2006.

By order of the Board
15 December 2006
Annex A

Amendments to the Glossary of definitions

In this Annex, underlining indicates new text and striking through indicates deleted text. Where new definitions are being inserted, the text is not underlined.

Part 1: New definitions

Insert the following new definitions in the appropriate alphabetical position:

*ICA* *individual capital assessment.*

*individual capital assessment* (in *INSPRU* and *COB 6.12*) an assessment by a *firm* of the adequacy of its capital resources undertaken as part of an assessment of the adequacy of the *firm's* overall financial resources carried out in accordance with *GENPRU 1.2*.

Part 2: Amended definitions

Amend the following definitions as shown:

*realistic excess capital* (in relation to a *with-profits fund*) the excess, if any, of the realistic value of assets for the with-profits fund over the sum of the realistic value of liabilities and the risk capital margin for that fund, calculated in accordance with [has the meaning set out in *PRU 7.4.32R*](#).
Annex B

Amendments to Annex B (Chapters 1 and 2 of GENPRU) to the General Prudential Sourcebook Instrument 2006 (FSA 2006/40)

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

…

1.3.41 R (1) For the purposes of GENPRU and INSPRU, an insurer or a UK ISPV must apply GENPRU 1.3.14R to GENPRU 1.3.34R (Marking to market, Marking to model, Independent price verification, Adjustments or reserves) to account for:

(a) investments that are, or amounts owed arising from the disposal of:

…

(iv) units in UCITS schemes, non-UCITS retail schemes, recognised schemes and any other collective investment scheme falling within paragraph(1)(A)(d)(iv) of GENPRU 2 Ann 7R that invests only in admissible assets (including any derivatives or quasi-derivatives held by the scheme); and

(b) …

(2) …

…

2.1.18 R The CRR for any insurer to which this rule applies (see GENPRU 2.1.19R and GENPRU 2.1.20R) is the higher of:

(1) the MCR in GENPRU 2.1.2524AR; and

(2) the ECR in GENPRU 2.1.38R.

…

2.1.24 R Subject to GENPRU 2.1.26R, for an insurer carrying on general insurance business, the MCR in respect of that business is the higher of…

2.1.24A R Subject to GENPRU 2.1.26R, for an insurer carrying on long-term
insurance business to which GENPRU 2.1.18R applies the MCR in respect of that business is the higher of:

(1) the base capital resources requirement for long-term insurance business applicable to that firm; and

(2) the long-term insurance capital requirement.

2.1.25 R Subject to GENPRU 2.1.26R, for an insurer carrying on long-term insurance business, but to which GENPRU 2.1.18R does not apply, the MCR in respect of that business is the higher of:

(1) the base capital resources requirement for long-term insurance business applicable to that firm; and

(2) the sum of:

(a) the long-term insurance capital requirement; and

(b) the resilience capital requirement.

2.1.27 G … The resilience capital requirement is an FSA requirement for regulatory basis only life firms that is additional to the EC minimum requirement for long-term insurance business.

…

2.1.38 R For an insurer carrying on long-term insurance business the ECR in respect of that business is the sum of:

(1) the long-term insurance capital requirement; and

(2) the resilience capital requirement; and

(3) the with-profits insurance capital component.

…
### Admissible assets in insurance

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<tr>
<th>(1)</th>
<th>(4A) Investments that are, or amounts owed arising from the disposal of:</th>
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<tr>
<td>(d)</td>
<td><em>units in</em></td>
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<td>(i)</td>
<td>UCITS schemes*</td>
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<td>(ii)</td>
<td>non-UCITS retail schemes*</td>
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<td>(iii)</td>
<td>recognised schemes* and</td>
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<td>(iv)</td>
<td>any other <em>collective investment scheme</em> where the <em>insurer's</em> investment in the scheme is sufficiently small to be consistent with a prudent overall investment strategy, having regard to the investment policy of the scheme and the information available to the <em>insurer</em> to enable it to monitor the investment risk being taken by the scheme that invests only in <em>admissible assets</em> (including any <em>derivatives</em> or <em>quasi-derivatives</em> held by the scheme);</td>
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| (2B) | Debts and claims |
| ... | |

| (3C) | Other assets |
| ... | |

| (e) | for *long-term insurance business* only, reversionary interests. |

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A firm may treat amounts recoverable from an *ISPV* as an *admissible asset* if it obtains a *waiver* under section 148 of the *Act*. The conditions that will need to be met, in addition to the statutory tests under section 148(4) of the *Act*, before the FSA will consider granting such a *waiver* are set out in *INSPRU 1.6.13G* to *INSPRU 1.6.18G*.

Subject to (3), where an asset would, but for this paragraph, be capable of falling into paragraph (1)(A)(d) above and one or more other categories in paragraph (1) above, that...
asset is only capable of falling into paragraph (1)(A)(d).

(3) Where an asset would, but for this paragraph, be capable of falling into paragraph (1)(A)(f) above and one or more other categories in paragraph (1) above, that asset is only capable of falling into paragraph (1)(A)(f).
Annex C

INSPRU 7.1

The following section is all new text, and is not underlined. This replaces the previous version of INSPRU 7.1

7.1 Individual Capital Assessment (ICA)

Application

7.1.1 R INSPRU 7.1 applies to an insurer unless it is:

(1) a non-directive friendly society; or

(2) a Swiss general insurer; or

(3) an EEA-deposit insurer; or

(4) an incoming EEA firm; or

(5) an incoming Treaty firm.

7.1.2 R Subject to INSPRU 7.1.3R, INSPRU 7.1 applies to managing agents and to the Society in accordance with:

(1) for managing agents, INSPRU 8.1.4R; and

(2) for the Society, INSPRU 8.1.2R.

7.1.3 R Managing agents must carry out assessments of capital adequacy for each syndicate they manage by reference to all open syndicate years taken together.

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 FSA. In GENPRU 2.1, the FSA sets minimum capital resources requirements for firms.
7.1.6 G The FSA 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 FSA is principally concerned with capital resources as calculated in accordance with GENPRU 2.2.17R. However, in carrying out its own assessment of its capital needs, a firm may take into account other capital available to it (see GENPRU 1.2.30R and GENPRU 1.2.36R), although it should be able to explain and justify its reliance on these other forms of capital.

7.1.8 G There are two main aims in this section:

(1) to enable firms to understand the issues which the FSA would expect to see assessed and the systems and processes which the FSA would expect to see in operation for ICAs by firms to be regarded as thorough, objective and prudent; and

(2) to enable firms to understand the FSA's approach to assessing whether the minimum capital resources requirements of GENPRU 2.1 are appropriate and what action may be taken if the FSA concludes that those requirements are not appropriate to a firm's circumstances.

General approach

7.1.9 G The rules in GENPRU 1.2 require a firm 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 firm should consider:

(1) the extent to which capital is an appropriate mitigant for the risks identified; and

(2) assess the amount and quality of capital required.

7.1.10 G GENPRU 1.2.42R requires a firm to carry out stress tests and scenario analyses for each of the major sources of risk identified in accordance with GENPRU 1.2.30R. A firm may also approach the assessment of the adequacy of its capital resources in another way. The method should be
proportionate to the size and nature of its business.

7.1.11  G  In accordance with GENPRU 1.2.60R, these assessments must be documented so that they can be easily reviewed by the FSA as part of the FSA’s assessment of the adequacy of the firm’s capital resources.

7.1.12  G  The FSA 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 FSA may also carry out a more detailed examination of the details of the firm's processes and calculations.

7.1.13  G  Based upon this information and other information available to it, the FSA 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 FSA’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 1.1.72CR. For realistic basis life firms, the ECR forms part of the CRR and is calculated in accordance with GENPRU 2.1.38R.

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 of the adequacy of its overall financial resources in accordance with GENPRU 1.2, 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.

Intra-group capital considerations

7.1.22 G It is common for firms whose corporate group consists of a number of separate legal entities to have intra-group transactions in place. Capital and risk may originate within the firm and be passed to another company or may originate in another company and be passed to the firm. The ICA should consider the underlying effect of intra-group arrangements.

7.1.23 G Risks may exist within the individual legal entity from these intra-group transactions. Intra-group transactions should not be treated differently from external transactions just because they are intra-group. However, some intra-group transactions may carry less credit risk than the equivalent external transactions if the firm has access to more information regarding the financial position of an internal reinsurer. In assessing intra-group risks, consideration should be given, but should not be limited, to:

1. future defaults on intra-group reinsurance arrangements: Firms should consider, for example, a test akin to the credit risk assessment undertaken on external reinsurance assets held or future anticipated recoveries; in other cases it may be more appropriate to perform a more explicit assessment of the group counterparty's own capital position, to inform the firm's exposure to default;

2. non-recoverability of intra-group loans: Even though these transactions occur within the same group, there is a risk that an entity may default on such intra-group payments; and

3. non-payment of future internal dividends or transfers: Many entities or funds within a group rely on these payments as a means to maintaining their solvency position. There is a risk that the entity paying the dividend or making the transfer may not be able to do so, and ICAs performed for separate regulated legal entities or funds within a group should consider these risks as appropriate.

7.1.24 G A firm's capital should normally be restricted to resources within the firm. Where the firm is relying on resources outside the direct control of the firm, these should only be included to the extent that the firm has a right to call on those resources and the provider has the ability to provide those resources without recourse to the assets of the firm itself, in the circumstances considered as part of 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 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 *FSA's Principles for Businesses*. In particular, a *firm* should take into account how the *FSA's Principles for Businesses* may constrain its prospective management actions, for example, *Principle 6* (Treating Customers Fairly).

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.

7.1.28 G Where the *ICA* assumes that the *firm* may move capital from one part of its business to another across legal or geographical boundaries, the *firm* should explain the mechanisms that it would apply and satisfy itself that it could achieve the necessary capital movements in times of distress (see *GENPRU 1.2.51R*). The *firm* should also consider any associated costs or restrictions in the amount of capital that would be able to be relocated.

**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 1.2.30R*).

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 7.1.30G*, 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
ICA submitted to FSA: confidence level

7.1.42 R Where the FSA 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 7.1.15R, 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 7.1.42R, firms should have regard to the guidance in INSPRU 7.1.21G, INSPRU 7.1.26G and GENPRU 1.2.27G to GENPRU 1.2.29G.

7.1.44 G The FSA requires firms to submit a capital assessment calibrated to a common confidence level, as set out in INSPRU 7.1.42R, to enable the FSA to assess whether the minimum capital resources requirements in GENPRU 2.1 are appropriate. This then allows the FSA 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 FSA

7.1.49 R The written record of a firm's individual capital assessments carried out in accordance with INSPRU 7.1.15R submitted by the firm to the FSA 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.

7.1.50 G A firm's management should determine their own risk appetite or confidence level and a risk measure that they believe is suitable for the management of the business. The FSA expects that the firm's capital resources assessment under GENPRU 1.2 which it uses in the management of its business may well be at a different confidence level than the 99.5% one required by INSPRU 7.1.42R for a number of reasons, for example, because its view of capital adequacy is different, or to satisfy the demands of rating agencies, or to meet the proposition to policyholders as to the strength of the firm. A firm will maintain its own written assessment of the adequacy of its financial resources, as required by GENPRU 1.2, through the written record requirement of GENPRU 1.2.60R.

7.1.51 G INSPRU 7.1.49R(2) recognises that a firm may carry out a number of different assessments of the adequacy of its capital resources, using different confidence levels, in reaching its overall assessment of the adequacy of its financial resources under GENPRU 1.2. The purpose of asking the firm to identify the major differences between those assessments and the assessment documented under INSPRU 7.1.49R(1) is to enable the FSA better to understand the firm's approach to capital adequacy and risk management in running its business. Understanding the written record made under GENPRU 1.2.60R is therefore key to the FSA's understanding of the firm's risk and capital management processes.

7.1.52 G The written record of any other assessment by the firm required by GENPRU 1.2.60R is not itself part of the submission to the FSA, but the
FSA is interested in the connection between that other assessment, as documented in the written record required by GENPRU 1.2.60R, and the assessment documented under INSPRU 7.1.49R(1) in terms of the firm's compliance with GENPRU 1.2, and the use of capital measures within the firm.

7.1.53 G For the purpose of the written record submitted to the FSA, the submitted comparison should include:

(1) A description of any direct difference in the strength of the firm's own assessment compared to the assessment submitted to the FSA. This is likely to be expressed as a different confidence level to the assessment undertaken to a 99.5% confidence level or the targeting of a defined margin about the 99.5% assessment.

(2) A description of any major differences in the definition of the assets or liabilities, the management actions used, the risks considered or the valuation methodology and assumptions included within the assessment.

7.1.54 G Some firms may not undertake an assessment at a separate confidence level because they consider that a 99.5% confidence level is appropriate to manage their business and meets the requirements of GENPRU 1.2. In the case of these firms, no analysis of the major differences is required to be submitted.

Justifying assumptions used

7.1.55 G Firms should provide evidence to support the choice of assumptions used within the ICA.

7.1.56 G Where the choice of assumptions is supported by data, the firm should consider the relevance of that data to the firm's current and future circumstances and the robustness of any estimates derived.

7.1.57 G Where the choice of assumptions is supported by expert judgement, the firm should consider the nature and value of the expertise being used to support this judgement and any biases that may exist. Where possible, the firm should use data to test and support these expert judgements.

Approach taken for significant assumptions

7.1.58 G Firms should be able to demonstrate how they have identified the most financially significant assumptions and calculate the sensitivity of the ICA to changes in these assumptions. The choice of assumption may be decided using the results of sensitivity testing.
7.1.59  
*Firms* may seek to justify their assumptions by considering the process used to determine those assumptions from relevant data. Alternatively, where historical data is either limited or not considered to be indicative of likely future experience, *firms* may justify their assumptions by reference to the suitability of the calibration for the purpose of the *ICA*. However, relatively more attention should be given to the justification where the choice of assumption has a more significant effect on the *ICA*.

7.1.60  
Where there is a concentration of business from a single source (for example, a single sales channel or cedant), consideration should be given to the greater impact of a risk crystallising, compared to that for a well-diversified portfolio.

**Justification of prospective management actions**

7.1.61  
Where projection of the value of assets and liabilities reflects the firm's prospective management actions, the firm should justify the choice of prospective management actions and the assumptions used.

7.1.62  
Where the prospective management action is identical to those used in another regulatory assessment of solvency (e.g. calculation of the *WPICC* for realistic basis life firms), no further justification is required.

7.1.63  
Where the prospective management action is not similar to those used in another regulatory assessment of solvency, or uses different assumptions, the firm should show the financial impact of the management action.

**Regular review of assumptions**

7.1.64  
*Firms* should regularly review key parameters, both to ensure their continued applicability and to reduce uncertainty over the current level of capital required. *Firms* using assumptions that are very different from past experience should present robust arguments in support of the differences.

**Methodology**

7.1.65  
The methodology used within the *ICA* should allow the firm to quantify the financial effect of material risks at the required confidence level. The methodology used should also reflect the nature of the firm's business and be consistent with the way in which the firm identifies and manages risk.

7.1.66  
*Firms* should be able to explain their rationale for choosing their approach to risk and assessment of capital required. There are no simple classifications of approach to risk and capital assessment, so the rationale should be considered in the context of a number of defining characteristics in the structure of the capital model.
7.1.67 G Generally, larger firms would be expected to take a more sophisticated approach to capital modelling than smaller ones.

Stress tests and scenario analyses

7.1.68 G A firm may choose to carry out the assessment of the adequacy of capital resources through the use of stress testing and scenario analysis (noting that GENPRU 1.2.42R requires stress tests and scenario analyses to be undertaken to determine the overall adequacy of a firm's financial resources). Where used, such testing should reflect the potential range of outcomes for the risks being quantified, consistent with the prescribed confidence level for the ICA.

7.1.69 G The overall assessment of capital required may require the aggregation of results from the stress and scenario testing. The firm should explain its choice of aggregation approach and its understanding of the implications of combining the individual risks. The firm should be satisfied that the resultant capital provides the required degree of confidence, given the variability of the underlying risks and the uncertainty associated with modelling those risks. A useful component of this process is the characterisation and explanation of a range of possible circumstances that could give rise to a loss of this magnitude.

Documenting the results

7.1.70 G The conclusion of the ICA should consider whether the firm has adequate capital to meet its assessment of the required capital. Furthermore, the firm should consider any implications for its approach to risk management arising from the work carried out. The ICA should be supported by an explanation of the material sources of risk and financial impact of the management actions that the firm may take to manage those risks. Where possible, the reasonableness of the results should be supported by considering other evidence of the capital needed.

7.1.71 G The objective of capital modelling is to consider all possible outcomes, however unlikely any one outcome might be, and set capital as protection against all but the most extreme losses. It is therefore important to focus not only on the assumptions and methodology used to quantify individual risks, but also on the approach to aggregating the capital required for each risk.

7.1.72 G However the risks have been aggregated to give the firm's capital requirement, checks should be made as to the reasonableness of the outcome. It should be possible to characterise scenarios, or combinations of loss events, that would result in a loss of similar magnitude to that indicated by the ICA. Firms should consider a range of scenarios that could give rise to such a loss.
7.1.73 G The results of the ICA should be supplemented by analysis of the sources of the risks to which the firm is exposed, discussion of the events which are most likely to threaten the financial stability of the firm and the potential mitigating actions which are available to senior management.

Additional guidance for Lloyd's

7.1.74 G Responsibility for:

(1) managing the risks associated with the insurance business; and
(2) holding the capital resources that support those risks;

is divided between managing agents and the Society. To clarify the respective responsibilities of managing agents and the Society for ensuring the adequacy of financial resources, the FSA distinguishes between the managing agents' responsibility to carry out capital adequacy assessments of the capital resources held at syndicate level for each syndicate that they manage, and the Society's responsibility to carry out an assessment for each member.

7.1.75 R In carrying out ICAs in respect of the insurance business carried on through each syndicate (the syndicate ICA), managing agents must consider the risks, controls and the financial resources relevant to each syndicate.

7.1.76 R When carrying out the syndicate ICA, managing agents must not take into account risks to which a member may be exposed or controls from which a member may benefit:

(1) because that member carries on insurance business through another syndicate or more than one syndicate year (whether or not managed by the same managing agent); or
(2) because that member's financial resources include funds at Lloyd's or central assets.

7.1.77 R The Society must have regard to syndicate ICAs in arriving at its own capital assessment for each member.

7.1.78 G In assessing the adequacy of the capital resources supporting the insurance business of each member, the Society should consider the risks, controls and financial resources relevant to the totality of the member's insurance business, including:

(1) the adequacy of syndicate ICAs;
(2) the member's share of syndicate ICAs;

(3) adjustments in respect of risks and controls relating to funds at Lloyd's, central assets and the interaction of risks underwritten by the member through different syndicates and in respect of different syndicate years; and

(4) the ongoing validity of any relevant assumptions it makes.

7.1.79 G In taking account of a syndicate ICA under INSPRU 7.1.77R:

(1) if the Society considers a syndicate ICA to be adequate, it should use the managing agent's risk and capital assessments in carrying out its ICA in relation to any member of that syndicate, or it should be able to justify why it will not; and

(2) if the Society considers a syndicate ICA to be less than adequate, the Society should increase the syndicate ICA so that it is adequate for the purpose of carrying out its ICA in relation to the members of that syndicate.

7.1.80 G The assessment of capital adequacy for a member will rarely equal the proportionate share of a syndicate ICA (or sum of those shares, where the member participates on more than one syndicate) as attributed to that member, because, in determining the capital assessments for each member, the Society may make adjustments to take account of:

(1) risks and controls associated with funds at Lloyd's and central assets, which can increase the assessment for that member;

(2) diversification effects, including as a result of members' participations on more than one syndicate year, which can reduce the assessment for that member; and

(3) its own assessment of syndicate risks, which can be higher than the managing agent's and so increase the assessment for that member.

7.1.81 G Capital resources to meet each syndicate ICA could be:

(1) held within a syndicate and managed by the managing agent; or

(2) held and managed by the Society; or

(3) not needed in full, because of effects such as diversification that the Society takes into account.
7.1.82 G The *balancing amount* is a function of the relationship between the *syndicate ICA* and the amount of assets held within the *syndicate*. As illustrations:

1. If the *syndicate* holds no *capital resources* (but its liabilities are fully covered by relevant assets), the *balancing amount* equals the *syndicate ICA* (as there are no *capital resources* at *syndicate* level, all the *capital resources* must be held as *funds at Lloyd's* or *central assets*);

2. If *capital resources* held at *syndicate* level are negative (i.e. if relevant assets do not fully cover liabilities for the *syndicate*), the *balancing amount* should be higher than the *syndicate ICA* by an amount corresponding to the negative *capital resources* held by *managing agents* on behalf of the *syndicate*; and

3. Conversely, if a *syndicate* holds positive *capital resources* for the *syndicate*, the *balancing amount* should be lower than the *syndicate ICA* by a corresponding amount.

7.1.83 R *Managing agents* must periodically notify the *Society* of the *syndicate ICA* and the *balancing amount* in respect of each *syndicate*.

7.1.84 R For the purpose of assessing the adequacy of *capital resources* held as *funds at Lloyd's* and *central assets*, the *Society* must have regard to *balancing amounts* notified to it by *managing agents*.

7.1.85 R After notification of a *balancing amount* by a *managing agent*, the *Society* must:

1. Confirm to the *managing agent* that *capital resources* held as *funds at Lloyd's* and *central assets* are adequate to support the *balancing amount*; or

2. Notify the *managing agent* that it cannot give that confirmation.

7.1.86 G *Managing agents* should submit *syndicate ICAs* and notify *balancing amounts* to the *Society* as part of the annual capital-setting process at Lloyd's. The submission of the *syndicate ICA* and the notification of the *balancing amount* should be made in good time for the *Society* to review them and place appropriate reliance on them when it determines the capital assessments for each *member*.

7.1.87 G When communicating the *syndicate ICA* and *balancing amount* for each *syndicate* to the *Society*, *managing agents* should agree with the *Society* an allocation of the *syndicate ICA* between *syndicate years*. The purpose of the allocation is to ensure that there is an appropriate matching of assets to risk
and liabilities and an equitable treatment between the members reflecting the provision of capital in each syndicate year.

7.1.88 G For the purposes of complying with their obligations under INSPRU, managing agents may assume that any balancing amount confirmed by the Society under INSPRU 7.1.85R is supported by capital resources held as funds at Lloyd's and central assets.

7.1.89 R If a managing agent has, at any time, a significant doubt about the adequacy of a syndicate ICA or balancing amount with respect to syndicate risks and controls, it must notify the Society immediately.

7.1.90 R If the Society has, at any time, a significant doubt about the adequacy of any member's capital resources held by it in support of any balancing amount, it must notify the relevant managing agent immediately.

FSA assessment process – all firms

7.1.91 G In assessing the adequacy of a firm's capital resources, the FSA 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 ARROW risk assessment and any other issues arising from day-to-day supervision will be considered.

7.1.92 G The FSA 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 ARROW review process as well as the review of the firm's ICA.

7.1.93 G A firm should not expect the FSA 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 FSA will take into account the results of any sound and prudent model when giving individual capital guidance or considering applications for a waiver under section 148 of the Act of the capital resources requirement in GENPRU 2.1.

7.1.94 G Where the FSA considers that a firm will not comply with GENPRU 1.1.26R (adequate financial resources, including capital resources) by holding the capital resources required by GENPRU 2.1, the FSA may give the firm individual capital guidance advising it of the amount and quality of capital resources which the FSA considers it needs to hold in order to meet that rule.
In giving *individual capital guidance*, the FSA 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 FSA 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.

Following an internal validation process, the FSA will write to the Board of the *firm* being assessed providing both quantitative and qualitative feedback on the results of the FSA'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.

If a *firm* considers that the *individual capital guidance* is inappropriate to its circumstances, then the *firm* should inform the FSA that it does not intend to follow that *guidance*. Informing the FSA of such an intention would be expected if a *firm* is to comply with Principle 11 (Relations with regulators).

The FSA expects most disagreements about the adequacy of capital will be resolved through further analysis and discussion. The FSA may consider the use of its powers under section 166 of the Act (Reports by skilled persons) to assist in such circumstances. If the FSA and the *firm* still do not agree on an adequate level of capital, then the FSA may consider using its powers under section 45 of the Act to, on its own initiative, vary a *firm's* Part IV *permission* so as to require it to hold capital in accordance with the FSA's view of the capital necessary to comply with GENPRU 1.2.26R. SUP 7 provides further information about the FSA's powers under section 45.

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 1.2.26R then the *firm* may apply to the FSA for a *waiver* of the requirements in GENPRU 2.1 under section 148 of the Act. In addition to the statutory tests under section 148, in deciding whether to grant a *waiver* and, if granted, its terms, the FSA 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. The FSA will not grant a *waiver* that would cause a breach of the minimum capital requirements under the Insurance Directives or Reinsurance Directive.
Annex D

Other amendments to Annex B (Text of INSPRU) to the Prudential Sourcebook for Insurers Instrument 2006 (FSA 2006/42)

In this Annex, underlining indicates new text and striking through indicates deleted text. Where a block of new text is inserted, this is indicated and the new text is not underlined.

…

1.1.11 G These requirements are dealt with in the part of this section headed "Capital requirements for insurers" (see INSPRU 1.1.43G to INSPRU 1.1.91R). That part of this section also contains rules about the calculation of the insurance-related capital requirement, which forms part of the enhanced capital requirement for firms carrying on general insurance business, including the calculation of the insurance-related capital requirement. The calculation of the asset-related capital requirement, which also forms part of the calculation of the ECR for firms carrying on general insurance business, is set out in INSPRU 2.2.

…

1.1.43 G (1) …

(2) For non-life firms the MCR represents the minimum capital requirement (or margin of solvency) prescribed by the Insurance Directives. GENPRU 2.1.24R provides that, for a firm carrying on general insurance business, the MCR in respect of that business is the higher of the base capital resources requirement for general insurance business applicable to that firm and the general insurance capital requirement. GENPRU 2.1.24AR provides that, for a firm carrying on long-term insurance business which is a realistic basis life firm, the MCR in respect of that business is the higher of the base capital resources requirement for long-term insurance business applicable to that firm and the long-term insurance capital requirement. GENPRU 2.1.25R provides that, for a firm carrying on long-term insurance business which is a regulatory basis only life firm, the MCR in respect of that business is the higher of the base capital resources requirement for long-term insurance business applicable to that firm and the sum of the long-term insurance capital requirement and the resilience capital requirement. As specified in GENPRU 2.1.14R, a firm carrying on both general insurance business and long-term insurance business must apply GENPRU 2.1.13R (referred to in paragraph (1) above) separately to
its general insurance business and its long-term insurance business.

(3) ...

...

1.1.66 R ...

(c) to account for premiums and claims which arose from contracts of insurance that have been transferred to the firm from another body as if they were receivable by or payable to by the firm.

...

1.1.69 G Conversely, INSPRU 1.1.66R(2)(c) requires a firm, for the purpose of calculating its GICR, to account for contracts of insurance transferred to it by another body as if it had been responsible for those contracts from inception and not merely from the date of transfer. All amounts of premiums and claims that arose from those contracts are included even where they arose prior to the date of transfer and were, in fact, receivable by or payable to by the other body.

...

Insert after INSPRU 1.1.72R the following new text, INSPRU 1.1.72AG to INSPRU 1.1.72DG, which is not underlined:

Enhanced capital requirement for general insurance business

1.1.72A G This section sets out the requirement for firms carrying on general insurance business, other than non-directive insurers, to calculate their ECR. The ECR for firms carrying on general insurance business is an indicative measure of the capital resources that a firm may need to hold based on risk sensitive calculations applied to its business profile. For firms carrying on general insurance business, the FSA will use the ECR as a benchmark for its consideration of the appropriateness of the firm’s own capital assessment. For firms where an ECR is not calculated, the MCR will provide a benchmark for the firm’s own capital assessment.

1.1.72B R A firm carrying on general insurance business, other than a non-directive insurer, must calculate the amount of its ECR.

1.1.72C R A firm to which INSPRU 1.1.72BR applies must calculate its ECR in respect of its general insurance business as the sum of:

(1) the asset-related capital requirement; and
(2) the insurance-related capital requirement; less
(3) the firm's equalisation provisions.

1.1.72D G Details of the calculation of the asset-related capital requirement are set out in INSPRU 2.2.10R to INSPRU 2.2.16R. Details of the calculation of the insurance-related capital requirement are set out in INSPRU 1.1.76R to INSPRU 1.1.79R.

Insurance-related capital requirement (general insurance business only)

1.1.73 G INSPRU 7.1.11R requires firms carrying on general insurance business, other than a non-directive insurer, to calculate their ECR as the sum of the asset-related capital requirement and the insurance-related capital requirement less the firm's equalisation provisions. The ECR for firms carrying on general insurance business is an indicative measure of the capital resources that a firm may need to hold based on risk sensitive calculations applied to its business profile. For firms carrying on general insurance business, the FSA will use the ECR as a benchmark for individual capital guidance for a firm carrying on general insurance business. Details of the calculation of the asset-related capital requirement are set out in INSPRU 2.2. Details of the calculation of the insurance-related capital requirement are set out in INSPRU 1.1.76R to INSPRU 1.1.79R.

1.1.80 G GENPRU 2.1.13R requires an insurer to maintain capital resources equal to or in excess of its capital resources requirement. GENPRU 2.1.18R defines the capital resources requirement for a firm to which that rule applies (a realistic basis life firm) as the higher of the MCR and the ECR. For other firms carrying on long-term insurance business (regulatory basis only life firms), the capital resources requirement is equal to the MCR. Except where the base capital resources requirement is the higher requirement, the MCR in respect of long-term insurance business is the sum of the long-term insurance capital requirement (LTICR) and the resilience capital requirement or, in the case of a realistic basis life firm, the LTICR (see GENPRU 2.1.24AR, GENPRU 2.1.25R and GENPRU 2.1.26R). GENPRU 2.1.36R defines the LTICR as the sum of the insurance death risk, health risk and life protection reinsurance, expense risk, and market risk capital components (see INSPRU 1.1.81R to INSPRU 1.1.91R). Rules and guidance about the resilience capital requirement are set out in INSPRU 3.1.9G to INSPRU 3.1.26R.

1.2.19 G Further detailed rules and guidance on margins for adverse deviation are included in INSPRU 1.2.32G to INSPRU 1.2.89G. In particular, the cross-references for the different assumptions used in calculating the mathematical
reserves are as follows:

... 

(4) persistency (INSPRU 1.2.73G to 1.2.76R and INSPRU 1.2.77G); and 

...

1.2.22 R (1) ...

(2) Approximations or generalisations may be made:

(a) in the case of non-attributable expenses, in relation to a group of contracts with the same or similar expense risk characteristics, provided that the mathematical reserves in respect of such expenses established by the firm in relation to that group of contracts have a minimum value of at least zero; and

(b) in any other case, where they are likely to provide the same, or a higher, result than a determination made in accordance with (1).

(3) ...

(4) For the purpose of (2), non-attributable expenses are expenses which are not directly attributable to a particular long-term insurance contract.

1.2.23 G INSPRU 1.2.22R to INSPRU 1.2.89G set out rules and guidance for the separate prospective valuation of each contract. These may be applied instead to groups of contracts where the conditions set out in INSPRU 1.2.22R(2)(a) or (b) are satisfied. Guidance on non-attributable expenses and the application of INSPRU 1.2.22R(2)(a) is provided in INSPRU 1.2.54AG.

Contracts not to be treated as assets

1.2.24 R (1) A firm must not treat a long-term insurance contract as an asset.

(2) (1) does not apply to a pure reinsurer in respect of a contract of insurance which does not have a guaranteed surrender value and falls within: 
(a) its life protection reinsurance business; or

(b) its permanent health reinsurance business.

(3) Notwithstanding (2), the total mathematical reserves established by a pure reinsurer must have a minimum value of at least zero.

A firm may calculate a negative value for the mathematical reserves in respect of a long-term insurance contract provided that:

(1) this is based on assumptions which meet the general requirements for prudent assumptions as set out in INSPRU 1.2.10R and INSPRU 1.2.13R;

(2) the contract does not have a surrender value which at the actuarial valuation date is guaranteed; and

(3) the total mathematical reserves established by the firm have a minimum value of at least:

(i) where the firm's long-term insurance contracts include linked long-term contracts, the sum of the surrender values of all its linked long-term contracts at the actuarial valuation date; and

(ii) in any other case, zero.

1.2.25 G A separate prospective valuation for each contract may identify contracts for which the value of future cash inflows under and in respect of the contract
exceeds that of outflows. In these circumstances, the firm may calculate the mathematical reserves for that contract as having a negative value and that value is available to off-set mathematical reserves for other contracts which have a positive value when establishing the overall mathematical reserves. However, the Consolidated Life Directive requires that no contract should be valued at less than its guaranteed surrender value (see INSPRU 1.2.62AG). As a result, no contract with a guaranteed surrender value to which the Consolidated Life Directive applies should be valued as if it were an asset. Although the Reinsurance Directive does not require this treatment of contracts with guaranteed surrender values to be applied to pure reinsurers, the FSA’s policy is that there should be equal treatment in this respect. INSPRU 1.2.62R makes further provision relating to the mathematical reserves to be established in respect of such contracts. When considering the impact that the amount payable on surrender may have on the valuation of a contract, a firm should have regard to INSPRU 1.2.71R.

Avoidance of future valuation strain

1.2.26 R (1) …

(2) …

(3) Subject to (4), (1) may be applied to a group of similar contracts instead of to the individual contracts within that group.

(4) (1) must be applied to a group of contracts in relation to which mathematical reserves in respect of non-attributable expenses are established for that group of contracts in accordance with INSPRU 1.2.22R(2)(a), instead of to the individual contracts within that group.

…

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 (see INSPRU 1.2.22R(2)(b)). …

…

1.2.39 G The valuation method for future premiums in INSPRU 1.2.38R retains the difference, if any, between the gross premium and the net premium as an implicit margin available to finance future bonuses, expenses and other costs. It thus helps to protect against the risk that adequate resources may not be available in the future to meet those costs. Where expenses are not directly attributable to a particular contract, a firm may establish
mathematical reserves in respect of such expenses in relation to a group of contracts with the same or similar expense risk characteristics in accordance with INSPRU 1.2.22R(2)(a).

...  

1.2.54 G ...

1.2.54A G (1) A firm should attribute to an individual contract at least those expenses which are directly attributable to that contract including expenses which vary with the volume of business for that type of contract. Commission payments, charges to a fund on a 'per policy' basis and investment management fees are generally directly attributable. For expenses of the fund which are calculated directly based on actual expenses (and not calculated in accordance with a management services agreement), the attributable expenses will also include those costs which vary with the volume of business for that product, for example, salaries and accommodation costs of staff in a processing centre, printing and postage of communications to policyholders and associated computer services.

(2) Non-attributable expenses may include overheads which are relatively insensitive to the volume of business for the type of contract in question and an apportionment of group overheads. Examples of expenses that firms may consider non-attributable include salaries of head office staff involved in monitoring products and drafting standard communications to policyholders and allocated overheads for centralised functions such as human resources, finance and IT. Where non-attributable expenses arise in relation to a homogeneous risk group of contracts sharing the same or similar expense risk characteristics, a firm may determine the reserve for those expenses at the level of that risk group, provided that the reserve so established has a minimum value of at least zero (see INSPRU 1.2.22R(2)(a)). In identifying its homogeneous risk groups, a firm should consider all risks that impact on the level of expenses borne by contracts including persistency risk and expense inflation risk. For example, business that is subject to bulk lapse risk, such as any large group contract that would give rise to a reduction in surplus on lapse, should be considered as forming a homogeneous risk group of its own. A firm must document and justify its approach to identifying homogeneous risk groups in accordance with the record-keeping requirements of INSPRU 1.2.20R. This approach to reserving for expenses ensures that prudent reserves are established in respect of both directly attributable and non-attributable expenses arising in relation to the firm's long-term insurance business.

1.2.54B G In valuing cash flows in respect of commissions, a firm may wish to take into account any contractual arrangements for the "clawback" or repayment of commissions already paid in the event of voluntary discontinuance of a
contract of insurance. In deciding how to treat such arrangements in determining the mathematical reserves for a contract of insurance, the firm must use assumptions which meet the general requirements for prudent assumptions as set out in INSPRU 1.2.10R and INSPRU 1.2.13R. For example, the firm should establish prudent margins for adverse deviation in respect of the credit risk of the intermediary by whom the commission would be repayable.

...  
1.2.56  G The provision for future expenses, whether implicit or explicit, should include a prudent margin for adverse deviation in the level and timing of expenses (see INSPRU 1.2.13R to INSPRU 1.2.19G). The margin should cover the risk of underestimating expenses whether due to, for example, initial under-calculation or subsequent increases in the amount of expenses. In setting the amount of the margin, the firm should take into account the extent to which:

(1) an appropriately validated method based on reliable data is used to allocate expenses by product type, by distribution channel and as between attributable and non-attributable expenses or between acquisition and non-acquisition expenses and by product type, by distribution channel or by homogeneous risk group, as appropriate;

...  
1.2.62  R ...  
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.

...  
1.2.64  G The firm should provide for the benefit which the firm anticipates the policyholder is most likely to choose. Except for the "option" of voluntary discontinuance in the case of regulatory basis only life firms (see INSPRU 1.2.74R), 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.

1.2.73 **G** INSPRU 1.2.76R and INSPRU 1.2.77G apply to the valuation of the with-profits insurance liabilities of realistic basis life firms. INSPRU 1.2.76AR and INSPRU 1.2.77G apply to the valuation of liabilities arising from the life protection reinsurance business and permanent health reinsurance business of pure reinsurers. INSPRU 1.2.74R and INSPRU 1.2.75G apply to the valuation of all other liabilities. [intentionally blank]

1.2.74 **R** Except as permitted by INSPRU 1.2.76R and INSPRU 1.2.76AR, a firm must not make any allowance in the calculation of the mathematical reserves for the voluntary discontinuance of any contract of insurance if the amount of the mathematical reserves so determined would, as a result, be reduced. [intentionally blank]

1.2.75 **G** The rate of voluntary discontinuance (that is, lapse, surrender or paying up) is often difficult to predict and may be volatile especially in the short term during stressful economic conditions. Depending upon the circumstances and contract terms, voluntary discontinuance may increase or decrease the firm’s liability. In effect, INSPRU 1.2.74R requires a firm to assume that there will be no voluntary discontinuance if assuming voluntary discontinuance would reduce the liability. This protects against the risk that arises from volatility in the rate of voluntary discontinuance. In addition, there is the risk of assets not being realisable when needed due to the rates of discontinuance exceeding expected levels. [intentionally blank]

1.2.76 **R** A realistic basis life firm may make assumptions about voluntary discontinuance rates in the calculation of the mathematical reserves for its with-profits insurance business provided that those assumptions meet the general requirements for prudent assumptions as set out in INSPRU 1.2.10R and INSPRU 1.2.13R.

1.2.76A **R** A pure reinsurer may make assumptions about voluntary discontinuance rates in the calculation of the mathematical reserves in respect of contracts of insurance falling within:

(1) its life protection reinsurance business; or

(2) its permanent health reinsurance business;

provided that those assumptions meet the general requirements for prudent
assumptions as set out in *INSPRU 1.2.10R* and *INSPRU 1.2.13R*.

...  

1.3.7  R  (1) The *with-profits insurance capital component* for a *firm* is the aggregate of any amounts that:

(a) result from the calculations specified in (2) and (3); and

(b) are greater than zero.

(2) Subject to (3), in relation to each *with-profits fund* within the *firm*, the *firm* must deduct B from A, where:

(a) A is the amount of the *regulatory excess capital* for that fund (see *INSPRU 1.3.23R*); and

(b) B is the amount sum of:

(i) the *realistic excess capital* for that fund (see *INSPRU 1.3.32R*);

(ii) the value, in the most adverse scenario required by *INSPRU 1.3.43R(3)*, of future internal transfers from the fund to shareholders or another of the *firm’s funds* in respect of the future distribution of surplus between *policyholders* and shareholders; and

(iii) an amount not exceeding the value, in the most adverse scenario required by *INSPRU 1.3.43R(3)*, of any other future internal transfers from the fund to a *non-profit fund* in respect of expense-related charges to the extent that the future receipt of the amount transferred is not already taken into account in the calculation of the *firm’s capital resources* or in establishing its *technical provisions*.

(3) Where a capital instrument that can be included in the *firm’s capital resources* in accordance with *GENPRU 2.2* has been attributed wholly or partly to a *with-profits fund* and that instrument meets the requirements of *GENPRU 2.2.271R*, the *firm* must add to the amount calculated under (2) for that fund the result, subject to a minimum of zero, of deducting D from C where:

(a) C is the outstanding face amount of the instrument to the extent attributed to the fund; and

(b) D is the realistic value of the instrument to the extent attributed to the fund in the single event that determines the *risk capital margin* under *INSPRU 1.3.43R*.  

34
Future internal transfers from a with-profits fund are included in the realistic value of liabilities (see INSPRU 1.3.105R, INSPRU 1.3.119R, INSPRU 1.3.128R and INSPRU 1.3.165R). INSPRU 1.1.27R ensures that sufficient assets are maintained in a with-profits fund to meet those future internal transfers. In calculating the WPICC, the economic value to the firm of those future transfers in the most adverse scenario required in calculating the risk capital margin (see INSPRU 1.3.43R) should be recognised. In the case of internal transfers to a non-profit fund in respect of expense-related charges, those transfers may only be recognised to the extent that those cash flows have not already been taken into account in calculating the firm's capital resources or technical provisions. In effect, the future asset of the shareholders or another of the firm's funds is available to offset the corresponding liability of the with-profits fund and should, therefore, subject to the limitation in INSPRU 1.3.7R(2)(b)(iii), be treated as capital arising from that fund which is available to reduce the amount of the WPICC.

A firm must calculate the regulatory excess capital for each of its with-profits funds by deducting B from A, where:

(1) …

(2) B is the sum of:

(a) the regulatory value of liabilities of the fund (INSPRU 1.3.29R); and

(b) the long-term insurance capital requirement in respect of the fund's with-profits insurance contracts;

(e) the resilience capital requirement in respect of the fund's with-profits insurance contracts.

Where non-profit insurance contracts are written in a with-profits fund, the amount representing those contracts is the sum of:

(a) the mathematical reserves in respect of the non-profit insurance contracts written in the fund; and

(b) the following amounts, to the extent that each of them is covered by the fund's long-term admissible assets:
(i) an amount in respect of the non-profit insurance contracts written in the fund which represents an appropriate allocation of the firm's long-term insurance capital requirement, to the extent that it is covered by the fund's long-term admissible assets; and

(ii) an amount in respect of the non-profit insurance contracts written in the fund which represents an appropriate allocation of the firm's resilience capital requirement.

1.3.27 G In calculating the amount of a firm's resilience capital requirement allocated to the non-profit insurance contracts in the with-profits fund, the firm should calculate the amount of resilience capital that would be required if that business were in a stand-alone company owning the assets allocated. The resilience capital requirement for the with-profits insurance business should also be calculated as if it were a stand-alone company. An allocation of the firm's total resilience capital requirement should then be made in a manner that would produce a result materially consistent with an allocation in proportion to the amounts calculated for each part of the business as stand-alone entities. [intentionally blank]

1.3.33 R (1) ...

(2) ...

(3) For the purposes of (2):

(a) ...

(b) ...

and D is equal to the sum of:

(v) the long-term insurance capital requirement in respect of any non-profit insurance contracts written in a non-profit fund of B;

(vi) where B is a regulatory basis only life firm, the amount of the resilience capital requirement in respect of any non-profit insurance contracts written in a non-profit fund of B;

(vii) any part of the with-profits insurance capital component of B, or of B's long-term insurance capital requirement or, where B is a regulatory basis only life firm, resilience capital requirement in respect of B's with-profits insurance contracts, that is not covered from the assets of the with-
profits fund from which it arises after deducting from those assets the amount calculated under (iv); and
(viii) any assets of B that back its regulatory capital requirements and that are valued in (iii) in the calculation of the present value of future profits of non-profit insurance business written by B.

(4) …

1.3.38 G In calculating the present value of future profits (or losses) for non-profit insurance business required by INSPRU 1.3.33R(1)(c), to the extent that the long-term insurance capital requirement and the resilience capital requirement are covered by the with-profits fund's long-term admissible assets, a firm may take into consideration any release of these items this item as the relevant policies go off the books.

1.3.39B G In determining current market yields for the purpose of INSPRU 1.3.37R(4), a firm is required to have regard to IFRS 4 as if it were being applied to determine the value under that standard for the first time, that is, without reference to existing practices. Paragraph 27 of the standard is likely to be of particular relevance. In general, a firm should not only include an allowance for future investment margins if its assumptions are limited to no more than a risk-free rate and the discount rate is set consistently until they are earned. In particular, a firm should not include an allowance for capital growth in determining current market yields for equities and real estate investments. However, this does not preclude a firm from using a replicating portfolio of assets to determine the discount rate for the liability with suitable adjustments for differences in their characteristics (for the example of annuity business, see INSPRU 1.3.39G). In setting assumptions for future investment returns, a firm should also consider sections BC134 to BC144 of the Basis for Conclusions in IFRS 4.

1.3.65 G In relation to the market risk scenarios in INSPRU 1.3.68R and INSPRU 1.3.73R, the effect of INSPRU 1.3.52R and INSPRU 1.3.58R is that a firm may reflect management actions and must make a realistic assessment of policyholder actions in projecting the assets and liabilities in its calculation of the risk capital margin for a with-profits fund within the firm. This contrasts with the position for calculating the resilience capital requirement for the firm (INSPRU 3.1.9 G to INSPRU 3.1.26R).
1.3.108 **G** *INSPRU 1.3.105R(7) requires firms to provide fully for shareholder transfers. Such transfers do not therefore count as capital in the *with profits fund*. However, a firm may apply under section 148 of the *Act* for a waiver from this requirement. In exercising its discretion under section 148 of the *Act*, the FSA will have regard (among other factors) to whether a firm has put in place undertakings satisfactory to the FSA, including that future transfers will not be paid out of the firm by way of dividend. [intentionally blank]

1.4.9 **G** However, firms are permitted to include *equalisation provisions* within their financial resources when demonstrating compliance with non-Directive capital requirements. Hence *equalisation provisions* are deducted from the available *capital resources* of a firm for the purpose of meeting its *minimum capital requirement* for general insurance business; but, in the calculation of a firm's *enhanced capital requirement* for general insurance business under *INSPRU 7.1.11R* to *INSPRU 1.1.72CR*, its *equalisation provisions* (if any) are added back to its *capital resources*.

1.5.44 **R** For the purposes of *INSPRU 1.5.42R*, a *non-EEA direct insurer* (except a *UK-deposit insurer*) must calculate a *UK MCR*:

(1) for *long-term insurance business*, in accordance with *GENPRU 2.1.36R* to *INSPRU 1.1.91R* but only in relation to business carried on by the firm in the *United Kingdom*;

(2) for *general insurance business*, in accordance with *GENPRU 2.1.34R* to *INSPRU 1.1.72R* but only in relation to business carried on by the firm in the *United Kingdom*.

1.5.46 **R** For the purposes of *INSPRU 1.5.42R*, a *UK-deposit insurer* must calculate an *EEA MCR*:

(1) for *long-term insurance business*, in accordance with *GENPRU 2.1.36R* to *INSPRU 1.1.91R* but only in relation to business carried on by the firm in all *EEA States*, taken together;

(2) for *general insurance business*, in accordance with *GENPRU 2.1.34R* to *INSPRU 1.1.72R* but only in relation to
business carried on by the firm in all EEA States, taken together.

2.1.22 R ...

(3) ...

c) ...

(i) ...

(ii) 1% for that part of the exposure arising from shares and other variable yield participations, bonds, debt securities and other money market instruments and capital market instruments from the same counterparty that are not dealt in on a regulated market, or any beneficial interest in a collective investment scheme which is not a UCITS scheme, a non-UCITS retail scheme or a recognised scheme to which INSPRU 2.1.39R applies; the limit for that part of the exposure arising from debt securities (other than hybrid securities) issued by the same regulated institution is increased to 5%;

(iii) ...

(e) 10% for the aggregate of all counterparty exposures and asset exposures that fall within (c)(ii) above or (i) below, whether or not they arise from persons who are closely related, but excluding amounts that are in excess of the limit in (c)(ii) above or, in the case of an asset exposure, (j) below;

(h) 10% for the asset exposure (including an exposure arising from a reversionary interest) arising from any one piece of land or building, or a number of pieces of land or buildings close enough to each other to be considered effectively as one investment;

(i) 5% for the asset exposure arising from a beneficial interest in any single non-UCITS retail scheme or recognised scheme which does not fall within the UCITS Directive; and

(j) 1% for the asset exposure arising from a beneficial interest in any single collective investment scheme which does not fall
within the *UCITS Directive* and is not a *non-UCITS retail scheme* or a *recognised scheme*.

(4) In (3) a firm's business amount means the sum of:

(a) …

(b) …

(c) …

(ii) in the case of a firm carrying on *long-term insurance business*, the amount of its *long-term insurance capital requirement* and, where it is a *regulatory basis only life firm*, the amount of its *resilience capital requirement*.

…

2.1.39 R For the purposes of *INSPRU 2.1.20R* and *INSPRU 2.1.22R*, a *UCITS scheme*, a *non-UCITS retail scheme*, a *recognised scheme* or any other collective investment scheme that invests only in admissible assets (including any derivatives or quasi-derivatives held by the scheme) is to be treated as closely related to the *issuer* of the *units* in that scheme if the *units* in a collective investment scheme that does not fall within the *UCITS Directive* must be treated as a *counterparty* exposure to the *issuer* if the *issuer* and those *units* are to be regarded as constituting a single risk because they are so interconnected that, if the *issuer* were to experience financial problems, this would be likely to affect the value of the *units*.

2.1.39A G Where the value of *units* in a collective investment scheme other than one falling within the *UCITS Directive* would be likely to be adversely affected by financial problems experienced by the *issuer* of those *units*, for the purposes of *INSPRU 2.1.20R* and *INSPRU 2.1.22R*, the *units* must be treated as a *counterparty* exposure to the *issuer*, with the result that the exposure is subject to the limit in *INSPRU 2.1.22R*(3)(c)(ii). In all other cases, the *units* would fall to be treated as an asset exposure, with the result that they are subject to the relevant limit under *INSPRU 2.1.22R*(3)(i) or (j).

Meaning of closely related

2.1.40 R For the purposes of *INSPRU 2.1*, a group of *persons* is closely related if it consists solely of two or more natural or legal persons *persons* who, unless it is shown otherwise, constitute a single risk because as between any two of
them one or other of the following relationships apply:

1. one of them, directly or indirectly, has control, as defined in INSINU 2.1.41R, over the other or they are both controlled by the same third party; or

2. there is no relationship of control as defined in INSINU 2.1.41R but they are to be regarded as constituting a single risk because they are so interconnected that, if one of them were to experience financial problems, the other would be likely to encounter repayment difficulties.

3.1.7 G INSINU 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 which is a regulatory basis only life firm must comply with the resilience capital requirement. This requires the firm to hold capital to cover market risk. The resilience capital requirement is dealt with in INSINU 3.1.9G to INSINU 3.1.26R.

3.1.9 G The resilience capital requirement forms part of the calculation of the capital resources requirement for regulatory basis only life firms. GENPRU 2.1.23R specifies that the CRR for a regulatory basis only life firm is equal to the MCR in GENPRU 2.1.25R. The resilience capital requirement forms part of the MCR for a regulatory basis only life firm (see GENPRU 2.1.25R(2)(b), all firms carrying on long-term insurance business. GENPRU 2.1.18R to GENPRU 2.1.23R set out the different elements of this calculation. These include the Minimum Capital Requirement and the Enhanced Capital Requirement. The resilience capital requirement forms part of both of these requirements (see GENPRU 2.1.25R(2) and GENPRU 2.1.38R(2)).

3.1.10 R (1) A regulatory basis only life firm that carries on long-term insurance business must calculate a resilience capital requirement in accordance with (2) to (5).
The resilience capital requirement requires firms to assume different adverse market risk scenarios for equities, real estate and fixed interest securities (see INSPRU 3.1.16R and INSPRU 3.1.23R) to those required by INSPRU 1.3.68R (UK and certain other assets) and INSPRU 1.3.73R (non-UK assets) in relation to the calculation of the risk capital margin for a with-profits fund by a realistic basis life firm calculating its with-profits insurance capital component.

The rates of interest required by INSPRU 1.2.33R to be used by a firm for the calculation of the present value of a long-term insurance liability must not exceed 97.5% of the risk-adjusted yield (see INSPRU 3.1.30R to INSPRU 3.1.48G) that is expected to be achieved on:

(4a) the assets allocated to cover that liability;

(2b) the reinvestment of sums expected to be received from those assets (see INSPRU 3.1.45R to INSPRU 3.1.48G); and

(3c) the investment of future premium receipts (see INSPRU 3.1.45R to INSPRU 3.1.48G).

(1) does not apply to a long-term insurance contract in respect of which the firm has calculated a negative value for the mathematical reserves in accordance with INSPRU 1.2.24R.

INSPRU 3.1.28R and INSPRU 3.1.29A G INSPRU 3.1.28R applies only applies to a long-term insurance contracts in respect of which a firm has calculated mathematical reserves with a positive value that are treated as liabilities. Where a firm treats a long-term insurance contract as an asset, a firm may, however, also have long-term insurance contracts where the value of future cash inflows under and in respect of the contract exceeds that of outflows, allowing the firm to calculate a negative value for the mathematical reserves for that contract (see INSPRU 1.2.24R). In calculating the present value of future net cash flows under and in respect of the that contract, the firm must include margins for adverse variation in accordance with INSPRU 1.2.13R. These margins should include margins for market risk and, where relevant, credit risk. For those margins to be sufficiently prudent as required by INSPRU 1.2.13R, the rate of interest used may need to be higher than that which would apply under
8.1.7 G  ... INSPRU 7.1 contains rules and guidance on the assessment of capital adequacy for firms and INSPRU 7.1.57R 7.1.74G to INSPRU 7.1.70R 7.1.90R provide for the application of INSPRU 7.1 to the Society and managing agents.

INSPRU TP

Transitional provisions

...
Annex E

Amendments to Annex A (Chapter TP of GENPRU and GENPRU Schedules) to the General Prudential Sourcebook (Transitional Provisions and Schedules) Instrument 2006 (FSA 2006/51)

In this Annex, underlining indicates new text.

TP Transitional provisions

…

15 Admissible assets

Application

15.1 GENPRU TP 15 applies to an insurer which is not a pure reinsurer.

Duration of transitional

15.2 GENPRU TP 15 applies until 30 December 2007.

GENPRU 2 Annex 7R

15.3 R (1) In determining whether its assets are admissible assets, instead of applying GENPRU 2 Ann 7R, a firm may elect to treat as an admissible asset an asset that would have been an admissible asset for the purposes of the Integrated Prudential Sourcebook (PRU) as it was in force on 30 December 2006.

(2) (1) does not apply when determining whether a derivative or quasi-derivative is an approved derivative or approved quasi-derivative.

(3) If a firm applies (1) to any of its assets, it must do so for all of its assets except derivatives and quasi-derivatives.
Annex F

Amendments to Annex A (Amendments to the Glossary) to the CRD (Consequential Amendments) Instrument 2006 (FSA 2006/53)

In this Annex, underlining indicates new text and striking through indicates deleted text. Where different amendments are to be substituted for those currently set out in Annex A, this is indicated below.

...

Part 1B (New definitions taking effect on 1 January 2007)

supervisory review and evaluation process

the FSA’s assessment of the adequacy of certain firms’ capital, as more fully described in BIPRU 2.2.9G and INSPRU 7.1.8G 7.1.12G.

...

Part 2A (Revised definitions taking effect on 31 December 2006)

...

Substitute for the amendments to the definition of admissible asset the following:

admissible asset

(1) (in LLD for the purpose of the rules in GENPRU and INSPRU as they apply to members of the Society of Lloyd's, the Society and managing agents) an asset that, subject to paragraphs (2) and (3) of GENPRU 2 Ann 7R, falls into one or more categories in paragraph (1) of GENPRU 2 Ann 74R as modified by LLD 19.3.19R GENPRU 2.3.34R.

(2) otherwise:

(a) (in relation to an insurer which is not a pure reinsurer) an asset that, subject to paragraphs (2) and (3) of GENPRU 2 Ann 7R, falls into one or more categories in paragraph (1) of GENPRU 2 Ann 74R; or

(b) …
enhanced capital requirement

(1) (in relation to a firm carrying on general insurance business) the amount calculated in accordance with 
PRU 2.3.11RINSRU 7.1.11RINSRU 1.1.72CR.

(2) …