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Dear Sir

Response to Chapter 4 of FSA Consultation Paper 08/12 – Proposed amendments to Glossary and Insurance Prudential sourcebooks

Please find attached our comments in response to Chapter 4 of FSA Consultation Paper (CP) 08/12 – Proposed amendments to Glossary and Insurance Prudential sourcebooks. As the CP for this Chapter has only one question we have ordered our comments in Appendix 1 according to the location of the relevant points in the CP. In addition, we have included as Appendix 2 some comments on other aspects of the prudential rules and guidance applicable to insurers not addressed by this CP where we consider further clarification of, or modification to, rules or guidance would be beneficial.

We would be happy to discuss our comments further. Please contact Mike Vickery (0117 923 4222) should you wish to discuss or clarify any matter in the attached response.

Yours faithfully

PricewaterhouseCoopers LLP

Appendix 1

Comments on proposals set out in Chapter 4 of, and Appendix 4 to, CP 08/12

Limits on the use of different forms of capital: pure reinsurers and captive reinsurers (paragraph 4.9)

By definition every captive reinsurer is a pure reinsurer and so the words “or *captive reinsurer*” are redundant in the text of proposed GENPRU 2.2.34AR. This comment also applies to use of the phrase “a *pure reinsurer* or a *captive reinsurer*” in the proposed amendment to GENPRU 2.2.41R (and similarly applies to other uses of this phrase in the Handbook).

Consideration should be given to the impact of the proposed change on reporting in Forms 1 and 2 in the Insurance Annual Return. No change has been proposed to the calculation of the guarantee fund requirements shown at line 21 in these forms. For a pure reinsurer conducting both long-term and general insurance business a single guarantee fund requirement will now exist and so any guarantee fund requirement shown on Forms 1 and 2 will be notional. However, it would seem preferable for the sum of any notional guarantee fund requirements shown on Forms 1 and 2 to equal the actual guarantee fund requirement calculated by reference to GENPRU 2.2.34AR. However, where the “notional” guarantee fund requirement in respect of one type of business is calculated by reference to the BCRR and for the other type by reference to one third of the relevant Insurance Capital Requirement then the aggregate of these “notional” guarantee fund requirements as shown on Form 1 and Form 2 will exceed the actual guarantee fund requirement calculated by reference to GENPRU 2.2.34AR.

It is possible for a similar issue to arise in respect of the MCR shown at line 26 where a pure reinsurer conducting both general and long-term business has a single MCR calculated by reference to GENPRU 2.1.26R.

Negative mathematical reserves (paragraph 4.12)

We suggest amending the proposed final sentence of INSPRU 1.2.25G(2) to clarify that the restriction on offsetting negative mathematical reserves outside a with-profits fund against positive reserves within such a fund applies only for the purpose of INSPRU 1.1.27R and not to the calculation of overall mathematical reserves (where such offset may be permitted provided the conditions in INSPRU 1.2.24R are met).

Proposed amendment to final sentence of INSPRU 1.2.25G(2): “For the purpose of INSPRU 1.1.27R does not permit contracts with negative *mathematical reserves* written outside a *with-profits fund* are not permitted to be offset against contracts with positive *mathematical reserves* written within that fund.”

Interim actuarial valuation (rule 9.4(2)) (paragraph 4.20)

Following the proposed change we believe it would be appropriate for the reference to “rule 9.4” in rule 9.3A(4)(c) to be changed to a specific reference to “rule 9.4(1)(a)” to make it clear that a with-profits insurance capital component is required to be calculated as part of the half-yearly valuation performed under rule 9.3A.

Group capital adequacy rule (rule 9.42) (paragraph 4.22)

The wording of paragraph 4.22 appears misleading as it implies that currently the information required by rule 9.40(1A) may be required to be submitted “before production of the consolidated accounts”. This is not the case as submission is currently only required under rule 9.40(1A) where the ultimate EEA insurance undertaking “has published annual consolidated accounts”.

In the proposed rule 9.42(4A) we suggest amending “is required to publish” to “publishes” as rule 9.40(1A) is not limited to circumstances where the publication of consolidated accounts is a

requirement (i.e. submission under that rule will be required where consolidated accounts are published voluntarily).

Analysis of derivatives (Form 17) (paragraph 4.25)

A derivative contract is defined as a contract for differences, a future or an option. However, in the proposed revised Form 17 the term swap is introduced and is used separately from these terms. "Swap" is defined in the Handbook Glossary but the uses of the term in the instructions to Form 17 are not italicised and so it is unclear if it is intended that they take the Glossary definition. If it is intended that "swaps" are a subset of contracts for differences then the term is not needed to be included in the categories of derivatives in the first column of Form 17. In addition, the wording of certain notes should be clarified (e.g. in instruction 11 swaps are dealt with at points (b) – (d) and so presumably are not intended to be included within the reference to contracts for differences at point (a)). Clarification of the use of the term swap should therefore be given.

A number of undefined terms are used in the instructions to the Form (e.g. credit default swaps, credit total return swaps, credit linked notes, swaptions). Definition of these terms would aid consistency of application.

In instruction 11(c) credit default swaps are dealt with but not other types of credit derivative (such as credit total return swaps and credit linked notes). Clarification should be given as to how the notional amount should be calculated for all credit derivatives.

In instruction 11 the notional amount is currently not defined in respect of other options reported at lines 36 and 46. It is suggested that in instruction 11(f) the term "equity *options*" is replaced with "*options other than swaptions*".

Following the removal of comparatives from Form 17, reference to Form 17 and note 1711 should be deleted from paragraph 7 of Appendix 9.1 as Form 17 will now contain neither comparatives nor amounts brought forward from the previous year.

Rule 9.12(8) requires updating to reflect the introduction of de minimis limits for the completion of Form 17.

Long-term insurance business: Fixed and variable interest assets (Form 49) (paragraphs 4.31 – 4.33)

In accordance with instruction 8, the asset backed securities to be analysed at lines 71-74 are those included at lines 31-51. It is arguably anomalous that the analysis will therefore include any asset backed approved variable interest securities (reported at line 41) but will exclude any asset backed approved fixed interest securities (reported at lines 11 and 21).

In respect of assets where the rating is supported by a credit wrapper, it is arguably anomalous to include variable interest securities in this disclosure when the credit rating of such securities is not actually required to be disclosed.

The term "asset backed security" is defined in the Handbook Glossary but the uses of the term in the instructions to Form 49 are not italicised and so it is unclear if it is intended that they take the Glossary definition. The meaning of this term for the purposes of Form 49 should be clarified and, in addition, consideration given to defining other terms such as "credit wrapper" to aid consistency of application.

Long-term insurance business: indexed linked business (Form 56) (paragraph 4.34)

The comments above in respect of definition of terms on Form 49 apply equally to the revised Form 56.

Para 4.34 indicates that the “proposed subdivision ... mirrors that proposed for Form 49”. However, differences between the proposed Forms 56 and Forms 49 include:

- on Form 56 other variable interest securities will be required to be analysed by credit rating whereas on Form 49 they are not; and
- the analyses on Form 56 of asset backed securities and assets where the rating is supported by a credit wrapper exclude approved variable interest securities whereas on Form 49 such securities are included in these analyses.

Appendix 2

Other areas where we believe the prudential rules as applicable to insurers may benefit from amendment or clarification

Clarification of GENPRU 2.1.30R

In the penultimate line of the table at GENPRU 2.1.30R the reference to “*pure reinsurer*” would more appropriately read “*pure reinsurer excluding captive reinsurer*”

Clarification of INSPRU 1.5.11G

We believe INSPRU 1.5.11G (which deals with the application of section 1.5 of INSPRU) should be clarified. The guidance at INSPRU 1.5.11G indicates that all or some of the requirements of INSPRU 1.5 apply only to composites or to long-term insurers conducting both linked and non-linked business. INSPRU 1.5.11G is itself not consistent with the drafting of the rules within INSPRU 1.5 (many of which, such as the restriction of transfers out of the long term fund, appear applicable to all long-term insurers) or with certain other guidance (such as INSPRU 1.5.16G which states one of the purposes of the internal contagion rules is the separation of long-term insurance assets from shareholder funds which is relevant to all long-term insurers).

Clarification of INSPRU 2.1.22R(3)(b)

We believe guidance should be added indicating how this rule should be applied in circumstances where the total exposures which are greater than 5% arising from applying a 10% limit exceed 40%.

Correction of INSPRU 2.1.22R(5B)

The reference in this rule to “(3)(b)(i)” should be to “(3)(b)(ii)”.

Interpretation of INSPRU 6.1.34AG

Clarification would be welcome as to how this guidance should be applied in the case of a US insurer and, in particular, whether the trigger for regulatory intervention in the context of NAIC’s Risk Based Capital model should be taken to at the Company Action Level (being 200% of the ‘Authorized Control Level’) or the Regulatory Action Level (being 150% of the ‘Authorized Control Level’)

Deduction of assets in excess of market risk and counterparty exposure limits at stage G of the calculation of Group Capital Resources at INSPRU 6.1.43R

The rules in INSPRU 6.1 as currently drafted could be read as permitting any admissible assets of an insurance subsidiary that are in excess of the market risk and counterparty limits for the purposes of that subsidiary’s own solo-solvency calculation to count in full towards the Group Capital Resources of its insurance parent without being subject to any market risk and counterparty restrictions.

The deduction for assets in excess of the market risk and counterparty limits from Group Capital Resources at stage G of INSPRU 6.1.43R is performed by reference to INSPRU 6.1.75R(1). This rule requires the deduction to be calculated by reference to the “surplus assets” of an insurance subsidiary and surplus assets as defined (see INSPRU 6.1.74R(4)) would not appear to include any of the subsidiary’s assets that are in excess of market risk and counterparty limits for the purpose of that subsidiary’s own solo solvency calculation. This is notwithstanding the fact that such assets would be included in Group Capital Resources before deductions (stage C of the INSPRU 6.1.43R).

Clarification would be welcome as to whether the rules as drafted reflect the FSA's policy intention in this regard.

Contents pages to Volume 1 and Volume 2 of IPRU(INS)

The title of Appendix 9.6 in these contents pages should be amended to replace "reports of the auditor and actuary advising the auditor" with "report of the auditor" reflecting the actual title of Appendix 9.6.

IPRU(INS) Forms 13, 14 and 15 - Offset of debtors / creditors within different sub funds.

An issue that sometimes arises on the balance sheet (Forms 13, 14 and 15) is where the life fund as a whole has an asset (such as an admissible debtor) reflected in the accounts, but at the sub-fund level this is the net result of a larger debtor in one sub-fund and a creditor due to the same person in the other sub-fund. Guidance would be welcomed on the completion of Forms showing assets and liabilities at a sub fund level where either;

- an aggregate asset or liability of the company to a third party is comprised of a mixture of assets and liabilities at the fund or sub fund level; or
- the accounting records of the Company show amounts owing between funds or sub-funds.

Reporting by members of financial conglomerates under SUP 16.7.82R and SUP 16.7.83R

Under SUP 16.7.82R a firm that is a member of a financial conglomerate must submit financial reports to the FSA in accordance with the table in SUP 16.7.83R if its Part IV permission contains a relevant requirement where a relevant requirement is one that applies SUP 16.7.83R to the firm.

Guidance as to the circumstances in which a Part IV permission would be considered to apply SUP 16.7.83R to a Firm would be welcomed. The decision tree at IPRU(INS) 9.42C (which currently makes no reference to a relevant requirement) should be revisited to ensure there are no inconsistencies with the scope requirements at SUP 16.7.82R.

In addition there are obsolete references to PRU in the table at SUP 16.7.83R which should be updated.

Areas where the Handbook text does not reflect the underlying legal instruments

The following instances have been identified where the text as published in the Full Handbook on FSA's website does not correctly reflect the underlying legal instruments. These anomalies should be corrected.

Rule reference	Error	Relevant legal instrument ("LI")
IPRU(INS)		
Rule 9.20(4)(b)(iii)	"gross undiscounted provision" should be "gross undiscounted provisions"	LI 2005/03
Rule 9.42(4)	The final paragraph of this rule is duplicated in error at the end of rule 9.42(3)	LI 2005/60
Form 60	Line 11 column 4, line 31 columns 2, 3 and 4 and line 41 column 4 should be shaded	LI 2006/39
Appendix 9.6	In the heading "CERTIFICATE" should be "CERTIFICATES" and in paragraph 1(1) "rule 9.34" should be "rule 9.34(1)"	LI 2006/17
INSPRU		
1.4.7G	"Threshold in INSPRU 1.4.4G" should be "Threshold in INSPRU 1.4.44R"	LI 2006/42