Feedback

Feedback on the booklet would be welcomed. Any comments by readers or enquiries should be referred to Kim Harmer or James Smith of EY, preferably by e-mail to kharmer@uk.ey.com and jsmith6@uk.ey.com, or by telephone +44 (0)20 7951 0556 and +44 (0)20 7951 7811 respectively.

Disclaimer

Interpretations of the FCA or PRA Handbooks in this booklet, while believed to be correct, cannot be taken as sufficiently full, accurate or precise to apply to any particular situation; reference to the Handbooks themselves (or to related primary or secondary legislation) should be made in appropriate cases. Ernst & Young LLP accepts no responsibility for loss arising from any action taken or not taken by anyone using this publication.

Acknowledgement

This booklet was the brainchild of John Philpott, who produced numerous annual editions of the guide to insurance prudential regulatory returns for submission to the FSA and its predecessor regulators, over many years prior to his retirement from EY in 2012. Those responsible for the production of the present publication gratefully acknowledge all of the groundwork done by John, without which this booklet would not have been possible.
Glossary

In general, words and phrases are defined when they first appear in the text; for the most part the practice of the PRA and FCA Handbooks is followed, but a number of additional terms have been introduced in the interests of clarity. Any reference to a particular Chapter, rule, Form or Appendix should be taken, unless the context dictates otherwise, to indicate a Chapter of, rule set out in, Form prescribed by or Appendix to the Interim Prudential Sourcebook for Insurers. References to “chapter” or “appendix” with a lower-case first letter are internal references to this booklet.

The following abbreviations have been used in the text:

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Full Form</th>
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<tbody>
<tr>
<td>ABI</td>
<td>Association of British Insurers</td>
</tr>
<tr>
<td>CEIOPS</td>
<td>Committee of European Insurance and Occupational Pensions Supervisors (now EIOPA)</td>
</tr>
<tr>
<td>COBS</td>
<td>Conduct of Business Sourcebook</td>
</tr>
<tr>
<td>CP</td>
<td>Consultation paper</td>
</tr>
<tr>
<td>CRR</td>
<td>Capital resources requirement</td>
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<tr>
<td>DAC</td>
<td>Deferred acquisition costs</td>
</tr>
<tr>
<td>DTI</td>
<td>Department of Trade &amp; Industry¹</td>
</tr>
<tr>
<td>E</td>
<td>Evidential provision</td>
</tr>
<tr>
<td>ECR</td>
<td>Enhanced capital requirement</td>
</tr>
<tr>
<td>EEA</td>
<td>European Economic Area</td>
</tr>
<tr>
<td>EIOPA</td>
<td>European Insurance and Occupational Pensions Authority</td>
</tr>
<tr>
<td>FCA</td>
<td>Financial Conduct Authority</td>
</tr>
<tr>
<td>FICOD</td>
<td>Financial Conglomerates Directive</td>
</tr>
<tr>
<td>FICOD1</td>
<td>Financial Conglomerates Amending Directive (2011)</td>
</tr>
<tr>
<td>FOS</td>
<td>Financial Ombudsman Service</td>
</tr>
<tr>
<td>FOS Ltd</td>
<td>Financial Ombudsman Service Limited</td>
</tr>
<tr>
<td>FPC</td>
<td>Financial Policy Committee</td>
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<tr>
<td>FRS</td>
<td>Financial Reporting Standard</td>
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<td>FSA</td>
<td>Financial Services Authority</td>
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<tr>
<td>FSCS</td>
<td>Financial Services Compensation Scheme</td>
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<tr>
<td>FSMA</td>
<td>Financial Services and Markets Act 2000</td>
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<tr>
<td>G</td>
<td>Guidance</td>
</tr>
<tr>
<td>GAAP</td>
<td>Generally accepted accounting practice</td>
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¹ Now the Department for Business Innovation & Skills (BIS).
<table>
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<tr>
<th>Abbreviation</th>
<th>Full Form</th>
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</thead>
<tbody>
<tr>
<td>GCRR</td>
<td>Group capital resources requirement</td>
</tr>
<tr>
<td>GEN</td>
<td>General provisions</td>
</tr>
<tr>
<td>GENPRU</td>
<td>General Prudential Sourcebook</td>
</tr>
<tr>
<td>GICR</td>
<td>General insurance capital requirement</td>
</tr>
<tr>
<td>IAIS</td>
<td>International Association of Insurance Supervisors</td>
</tr>
<tr>
<td>IAS</td>
<td>International Accounting Standard</td>
</tr>
<tr>
<td>IBNR</td>
<td>Incurred but not reported</td>
</tr>
<tr>
<td>ICA</td>
<td>Individual capital assessment</td>
</tr>
<tr>
<td>ICG</td>
<td>Individual capital guidance</td>
</tr>
<tr>
<td>ICOBS</td>
<td>Insurance Conduct of Business Sourcebook</td>
</tr>
<tr>
<td>IFRS</td>
<td>International Financial Reporting Standard</td>
</tr>
<tr>
<td>IG</td>
<td>Individual guidance</td>
</tr>
<tr>
<td>IGD</td>
<td>Insurance Groups Directive</td>
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<tr>
<td>IMAP</td>
<td>Internal Model Approval Process</td>
</tr>
<tr>
<td>INSPRU</td>
<td>Prudential Sourcebook for Insurers</td>
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<td>IPRU(FSOC)</td>
<td>Interim Prudential Sourcebook for Friendly Societies</td>
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<tr>
<td>IPRU(INS)</td>
<td>Interim Prudential Sourcebook for Insurers</td>
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<tr>
<td>ISA</td>
<td>International Standard on Auditing</td>
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<tr>
<td>ISPV</td>
<td>Insurance special purpose vehicle</td>
</tr>
<tr>
<td>LTICR</td>
<td>Long-term insurance capital requirement</td>
</tr>
<tr>
<td>MCR</td>
<td>Minimum capital requirement</td>
</tr>
<tr>
<td>MFHC</td>
<td>Mixed financial holding company</td>
</tr>
<tr>
<td>ONA</td>
<td>Online Notification and Applications system</td>
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<tr>
<td>ORSA</td>
<td>Own Risk and Solvency Assessment</td>
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<tr>
<td>PPFM</td>
<td>Principles and Practices of Financial Management</td>
</tr>
<tr>
<td>PGN</td>
<td>Prudential Guidance Note</td>
</tr>
<tr>
<td>PRA</td>
<td>Prudential Regulation Authority</td>
</tr>
<tr>
<td>PRU</td>
<td>Integrated Prudential Sourcebook</td>
</tr>
<tr>
<td>PRIN</td>
<td>Principles for Businesses</td>
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<tr>
<td>QIS</td>
<td>Quantitative Impact Study</td>
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The following terms are used frequently in this booklet:


“Approach document” means the PRA’s April 2013 publication entitled The Prudential Regulation Authority’s approach to insurance supervision.

“ABI SORP” means the revised Statement of Recommended Practice on accounting for insurance business issued by the Association of British Insurers in December 2005 and amended in December 2006.


“Business amount” means the yardstick figure for admissibility purposes defined by INSPRU 2.1.22R(4).

“Direct insurer” means an insurer that is not a pure reinsurer.

“Directors’ certificate” means the certificate required by rule 9.34(1) to be given by specified officers of an insurer and annexed to the return.

“EEA direct insurer” means a direct insurer with its head office in an EEA State other than the United Kingdom, which carries on business in the United Kingdom through a branch.

“External direct insurer” means a direct insurer with its head office outside the EEA, other than a Swiss general insurer, which carries on business in the United Kingdom through a branch.

“Global return” means a return covering an insurer’s worldwide business.

“Grandfathering” means the continuing validity of a status prevailing prior to a change in regulation, where permitted under that change; and in particular, the provisions of GEN TP2 providing for continuing application of actions prior to legal cutover.

“Guidance Notes” means the Guidance Notes formerly contained within Volume 3 of IPRU(INS), all of which extant at 31 December 2004 were repealed at that date. Guidance Notes can nevertheless be seen as indicative of best practice in areas where the rules to
which they relate have not subsequently been changed. This booklet refers particularly to the repealed Guidance Note 9.1 on preparation of returns.

“Handbook” means the PRA Handbook or the FCA Handbook, containing rules and guidance made by or designated by those Regulators under the authority of FSMA, or (historically) the FSA Handbook of Rules and Guidance.

“Home foreign” means direct and facultative general insurance business carried on in the UK primarily relating to risks situated outside the UK, but excluding marine, aviation and transport business (categories 330, 340 and 350) and business where the risk commences in the UK.

“Insurance accounts rules” means the rules set out in Schedule 3 to the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008.

“Insurance group” means an insurance parent undertaking (or a participating insurance undertaking that is not an insurance parent undertaking) and its related undertakings.

“Insurance holding company” means a parent undertaking (other than an insurance undertaking) whose main business is to acquire and hold participations in subsidiary undertakings, where those subsidiary undertakings are exclusively or mainly insurance undertakings, and at least one of those insurance undertakings is a UK insurer or an EEA firm that is a regulated insurance entity. The definition excludes a mixed financial holding company (though parallel requirements for mixed financial holding companies were implemented in 2013). The parent of an ISPV does not fall within the definition by virtue of this alone.

“Legal cutover” is the point (1 April 2013) at which the FCA and PRA acquired their legal powers.

“MFHC conglomerate” means a financial conglomerate headed by a mixed financial holding company.

“Mixed financial holding company” means a parent undertaking, other than a regulated entity, which is at the head of a financial conglomerate.

“Mixed insurer” means a direct insurer which carries on reinsurance business exceeding prescribed materiality thresholds.

“N2” means the date (midnight at 30 November 2001) on which the provisions of FSMA came into force and the FSA assumed legal responsibility for the prudential supervision of insurers.

“Prudent person principles” means the principles set out in INSPRU 3.1.61AR, applicable to the investments of pure reinsurers and ISPVs.

“Pure reinsurer” means an insurer whose insurance business is as a matter of fact restricted to effecting or carrying out contracts of reinsurance.

“Quasi-derivative” means an instrument which has the characteristics of a derivative but takes some other legal form.

“Realistic basis life firm” means a firm that is required to calculate a with-profits insurance capital component by virtue of exceeding the threshold for with-profits insurance liabilities set out in GENPRU 2.1.19R(3) or because it has elected to have that status.


“Regulated activity” means an activity of a kind specified by the Regulated Activities Order carried on by way of business in the United Kingdom in relation to an investment of a kind specified by that Order.
“Regulator” means the PRA or FCA, or prior to 1 April 2013 the FSA, or prior to 2001 the DTI or HM Treasury.

“Regulatory basis life firm” means a firm carrying on long-term insurance business that is not a realistic basis life firm.

“Return” means the annual return which an insurer is required by the Accounts and Statements Rules to submit to the PRA.

“Section 68 Order” means an Order issued under section 68 of the 1982 Act which modified the requirements of the pre-N2 insurance legislation in respect of a particular insurer. All such Orders ceased to have effect at legal cutover.

“Solvency I” originally meant, and is used in this booklet to mean, the changes to the solvency requirements introduced by Directives 2002/12/EC and 2002/13/EC coming into effect for financial years beginning on or after 1 January 2004, which were intended to clarify, simplify, improve and update the existing rules, but has by extension become commonly applied to the collection of European Directives applicable to insurance, as in force prior to the implementation of Solvency II.

“Solvency II” means Directive 2009/138/EC and detailed provisions made thereunder, representing more fundamental changes to the regulation of insurers. The Solvency II regime was originally scheduled to come into force in November 2012 but is now expected to commence at the start of 2016.

“Super-combined category” means combined category 001 (total business), 002 (total direct and facultative business) or 003 (total treaty reinsurance accepted business).

“Swiss general insurer” means a direct insurer with its head office in Switzerland which carries on business in the United Kingdom through a branch.

“UK branch return” means a return covering the activities of a non-EEA insurer that are carried on in the United Kingdom through a branch.

“UK direct insurer” means a direct insurer with its head office in the United Kingdom.

“Waiver” means a direction given by a Regulator under section 138A of FSMA (or predecessor legislation) on the application or with the consent of an insurer directing that certain rules are not to apply to the insurer or are to apply with such modifications as may be specified in the direction.
Introduction

1. The social purpose of insurance is to enable policyholders to reduce their exposure to risk by substituting a known cost (the premium) for a potential loss or liability of an indeterminate amount (or, in the case of some forms of life insurance, timing), and failure of an insurer frustrates this social purpose, creating an interest for the State in regulating the market. Life assurance is also used by many as a convenient means of saving as well as protection, creating institutional investors redeploying the accumulated savings of many. State supervision in the UK is a matter of prevention; while not seeking to guarantee zero failures, the State seeks to reduce by regulation the probability of loss to society due to failure of insurance institutions arising from the normal operation of a competitive market, and thus to maintain confidence in insurance as a form of risk and financial intermediation.

2. Since 1 April 2013, a date referred to as “legal cutover”, the Prudential Regulation Authority (PRA), a subsidiary of the Bank of England, has been responsible for the prudential supervision of insurance companies, friendly societies, deposit-taking institutions and larger investment firms in the UK, while a separate organisation, the Financial Conduct Authority (FCA) has dealt with prudential supervision of other firms regulated under financial services legislation, conduct of business supervision for all firms and markets supervision. Prior to that, the Financial Services Authority (FSA) had had legal responsibility for the supervision of the insurance industry since 2001, as regards both prudential and conduct matters. The change in the supervisory architecture has had limited practical impact on the returns formerly made to the FSA, and now to the PRA, beyond necessary cosmetic changes, some improvements in lodgement efficiency and new rules for certain financial groups.

3. The detailed practical requirements for the preparation and lodgement of the annual PRA return are largely contained in the Interim Prudential Sourcebook for Insurers (IPRU(INS)) within the PRA Handbook. The FCA also has a Handbook, and the two Handbooks are inherited from the FSA’s Handbook of Rules and Guidance. They initially used identical indexing and a combined Handbook is available online; the term “Handbook” is in practice largely interchangeable for the present though this will not remain the case. Other Handbook modules are also of significance. The General Prudential Sourcebook for Banks, Building Societies, Insurers and Investment Firms (GENPRU) and the Prudential Sourcebook for Insurers (INSPRU) provide rules for determining many of the figures that are reported in the return. IPRU(INS) prescribes the form and content of the annual regulatory return.

4. The FSA regime emphasised “principles-based regulation”, the key concept underlying which is focus upon regulatory ends rather than the means by which these ends are achieved. The credibility of this approach suffered following the global financial crisis, and the PRA and FCA now emphasise judgement and a forward-looking approach. The recent nature of the changeover, with rule books inherited from the FSA (and in some cases, even its predecessor regulators), and the requirements of European Directives mean that the rules do not always reflect this emphasis. The majority of the return consists of prescribed Forms, but some of the underlying rules in GENPRU and INSPRU setting out the approach to be taken to arrive at the figures to be reported in the return require the careful exercise of judgement by senior management to determine whether the criteria set out have been satisfied. The PRA has already flagged an intention to look more closely at valuation uncertainty.

5. This booklet is intended as a successor to the publications that EY has previously produced on returns made by insurers to the FSA and predecessor regulators, the last edition of which was published in January 2013. It provides a guide to and a commentary on returns now made to the PRA under the Accounts and Statements Rules which are set out in Chapter 9 of IPRU(INS). The text also provides:

(a) an overview of the regime for insurance prudential regulation;
(b) an explanation of the underlying rules in GENPRU and INSPRU directly relevant to the return; and

(c) coverage of some of the information outside the annual return that insurers are required to report to the PRA routinely or on an ad hoc basis under the PRA Handbook.

6. However, this booklet focuses on the returns, not on insurance regulation as a whole. Some topics have been covered relatively lightly in order to keep the size of the booklet down to reasonable proportions, and to avoid straying too deeply into matters outside the authors’ area of specialist knowledge. This booklet is primarily directed at those with the responsibility for preparing the return. It is hoped that other parties who need to make use of the return will also find it helpful. The booklet needs to be read in conjunction with the PRA Handbook for which it is in no sense a substitute; indeed the many Forms prescribed by the Accounts and Statements Rules are not reproduced in this booklet. The PRA Handbook can be accessed online from the PRA website (http://fsandbook.info/FS/html/PRA), and the FCA Handbook from the FCA website (http://fsandbook.info/FS/html/FCA) a combined version is also available online (http://fsandbook.info/FS/html/handbook). External subscription websites also provide access.

7. The preparers of the present edition have sought to elide or edit some material of mainly historical interest that was present in earlier editions and is particularly useful for those seeking to understand FSA returns prepared in the past. The aim of the present booklet is to provide information on the contemporary requirements. The historical information is alluded to in the text where necessary. The present edition also concentrates on the prudential regulation framework and does not seek to describe in detail matters that are now the responsibility of the FCA.

8. The text of this booklet is based on the PRA Handbook as amended up to 31 December 2013.

9. 2013 has seen implementation of amendments to the Financial Groups Directive, effective from 30 June 2013, which may affect the scope of groups for which group capital adequacy data is reported by insurance firms. Changes have also been made to the reporting requirements for the handful of insurance firms that are required to report conglomerate group capital adequacy.

10. Necessary and largely cosmetic changes have been made to the form of the PRA return itself for financial years ending on or after 1 April 2013, to reflect legal cutover. The Accounts and Statements Rules now refer to the PRA rather than the FSA, and the addresses for lodgement have changed. With effect from 31 December 2013, lodgement may be completely electronic, and there is no longer a requirement for the return itself to be signed (in addition to the Directors’ Certificate).

11. Other practical matters include the prescribed sterling value of the Euro which has changed from 80.645p to 85.02p. This affects the base capital resources requirement reported on Forms 1 and 2, and the break points in the calculation of the general insurance capital requirements on Forms 11 and 12. However, unlike in the previous year, there has been no indexation uplift of the base capital resources requirement and the break points.

12. The relative stability in the regulatory reporting rules is unsurprising in view of the proximity of Solvency II. The Framework Directive\(^2\) for Solvency II was made during 2009 and was originally intended to come into force on 1 November 2012; however, continuing delays in the development of implementing measures and in the passage of the Omnibus II Directive mean that the expected implementation date is now 1 January 2016 and returns are likely to be prepared under the existing rules at least until and including 31 December 2015 (depending on any transitional arrangements).

\(^2\) Directive 2009/138/EC on the taking up and pursuit of the business of insurance and reinsurance.
The Directive provides a framework for harmonised regulatory reporting, with much of the supporting detail still in the course of being finalised. The mechanism for development of that material is that the European Insurance and Occupational Pensions Authority (EIOPA), which is made up of representatives of the supervisors of the different Member States of the EU, consults publicly on proposals for “Level 2” implementing measures and provides advice to the European Commission. EIOPA published in July 2012 its Final report on its “Draft proposal on Quantitative Reporting Templates and Draft proposal for Guidelines on Narrative Public Disclosure & Supervisory Reporting, Predefined Events and Processes for Reporting & Disclosure.” These templates will supersede the PRA returns as these currently exist, for the majority of insurers, although the Forms are likely to be retained in the short term for those insurers who are outside the scope of the Directive (e.g. on de minimis grounds), and for the PRA is likely to require some additional, UK-specific reporting. EIOPA has also since released similar templates for interim reporting, as part of its intended Preparatory Guidelines to be phased in over the two years prior to implementation of Solvency II. Appendix H to this booklet summarises the key features of Solvency II, and has been expanded and updated to reflect developments during 2013.

3 Before 2011, a predecessor body existed, with a less extensive role. This was the Committee of European Insurance and Occupational Pensions Supervisors (“CEIOPS”).
Contents

Chapter 1 – Background....................................................................................................1
Chapter 2 – Introduction to the Accounts and Statements Rules..................................24
Chapter 3 – Capital resources .........................................................................................39
Chapter 4 – Assets ...........................................................................................................62
Chapter 5 – Liabilities ......................................................................................................91
Chapter 6 – Revenue accounting – general insurance business .....................................105
Chapter 7 – Reinsurance ...............................................................................................136
Chapter 8 – Long-term insurance business ..................................................................150
Chapter 9 – Directors’ certificate and auditor’s report ................................................178
Chapter 10 – Groups .....................................................................................................186
Chapter 11 – Other reports to the PRA by insurers ......................................................203
Appendix A  Form 13 – Valuation of assets ...................................................................217
Appendix B  Supplementary Notes ..............................................................................226
Appendix C  Auditor’s report on the return ...................................................................241
Appendix D  Auditor’s statement on the group capital adequacy report ......................244
Appendix E  UK-deposit insurers and EEA-deposit insurers .........................................246
Appendix F  Marine Mutuals .......................................................................................248
Appendix G  Friendly Societies .....................................................................................252
Appendix H  Solvency II ...............................................................................................256
Chapter 1 – Background

This booklet concentrates on information to be reported by insurers to the Prudential Regulation Authority (PRA). It is however appropriate to put this in context by a general description of the current regime as it now applies to all authorised firms, following the changes that took effect on 1 April 2013.

This chapter also necessarily involves a degree of description of past requirements, though the main focus is on the present institutional architecture, and a high-level description of the arrangement of the prudential requirements that insurers are required to apply.

1. The regulatory architecture for insurance from 1 April 2013

1.1. 1 April 2013, a date referred to as ‘legal cutover’, heralded a new institutional structure for the regulation of insurance and other financial services firms in the UK. It brought to an end a period of transition to a structure that is designed to address perceived operational weaknesses in the institutional structure for financial services regulation in the UK, identified as a consequence of the financial crisis.

1.2. The Financial Services Act 2012 provided that at legal cutover, the Financial Services Authority (FSA), which since 2001 had been responsible for insurance regulation in the UK, would cease to exist in its then form. Certain responsibilities passed to the Bank of England, but the remainder of the organisation was in effect divided into two new regulatory bodies, the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA). Both Regulators are, as was the FSA, financed through fees paid by firms in the financial services sector. The principal rationale for this change was a perception of real and significant failings in the UK regulatory system during the run-up to the global financial crisis of the latter part of the “noughties”. In particular, the system failed to identify the problems that were building up in the financial system, to take steps to mitigate them before they led to significant instability in financial markets and to deal adequately with the crisis when it did break, especially during the first part of the crisis in the summer of 2007. The problem was seen as arising from the tripartite system whereby the Bank of England, the FSA and the Treasury were collectively responsible for financial stability. The tripartite model was seen as containing a number of inherent weaknesses and contradictions. In particular:

► Responsibility for all financial regulation was in the hands of a single, monolithic financial regulator (the FSA), which was expected to deal with issues ranging from the safety and soundness of the largest global investment banks to the customer practices of the smallest high-street financial advisor.

► The Bank of England had nominal responsibility (and since the Banking Act 2009 statutory responsibility) for financial stability, but was not provided with the tools or levers to carry out this role effectively.

► The Treasury had responsibility for maintaining the overall legal and institutional framework, but no clear responsibility for dealing with a crisis that put tens of billions pounds’ worth of public funds at risk.

1.3. The most obvious failing of the UK system was the fact that no single institution had the responsibility, authority or powers to monitor the financial system as a whole, identify potentially destabilising trends and respond to them with concerted action (a phenomenon referred to as “underlap”). This was seen as compounded by the adoption by the FSA of a ‘tick box’ approach to compliance with rules and directives at the expense of proper in-depth and strategic risk analysis.

1.4. A number of Treasury Consultation Papers culminated in a White Paper in June 2011 setting out a proposed new approach to financial regulation. Following pre-legislative scrutiny by a Joint Committee of both Houses of Parliament and by the Treasury Committee, the Government delivered its response to the Committees’ recommendations in a further
Treasury document, *A new approach to financial regulation: securing stability, protecting consumers* (January 2012). Final legislative proposals took form in the Financial Services Act 2012. Rather than replacing the Financial Services and Markets Act 2000 (FSMA), the predecessor legislation, this Act amended FSMA (extensively) and other relevant legislation to give the powers and make the relevant changes required. It also reflected events occurring during the period of legislative process, notably the LIBOR benchmark fixing scandal, where the Act creates powers to regulate the setting of market benchmarks.

1.5. Institutionally, the new Act made four changes:

(a) The Bank of England Act was amended to provide *inter alia* for the creation of a Committee of its Court of Directors, known as the Financial Policy Committee (FPC). This Committee has responsibility for ‘macro-prudential’ regulation (regulation of the stability and resilience of the system as a whole). A new Schedule to the Bank of England Act sets out the basis for its constitution, appointment, proceedings and other details including reporting responsibilities. The members include, *ex officio*, the Governor and Deputy Governors of the Bank, and the Chief Executive of the FCA, as well as appointed members. The powers of the FPC include ability to direct the PRA and FCA in respect of macro-prudential measures, and to make recommendations to them (and to the Bank itself).

(b) Provision was made for the establishment of the PRA as an operationally independent subsidiary of the Bank of England, to be responsible for the ‘micro-prudential’ regulation of entities that manage significant levels of risk and thus require a sophisticated level of prudential regulation (deposit-taking institutions, insurers, friendly societies and large investment firms). The PRA is chaired by the Governor of the Bank of England, and its Chief Executive is a Deputy Governor of the Bank, responsible for prudential regulation. It is a company limited by shares. It has a general objective of protecting the safety and soundness of PRA-authorised persons, and an ‘insurance objective’ of contributing to the securing of an appropriate degree of protection for those who are or may become policyholders.

(c) Provision was also made for the FSA, which is a company limited by guarantee (and was until October 1997 known as the Securities and Investments Board, one of the FSA’s nine predecessor regulators), to be re-established as the FCA, to take responsibility for the business conduct aspect of financial regulation; the FCA is an independent regulator charged with ensuring that the markets for which it is responsible function well, and with three operational objectives focused on market integrity, consumer protection and effective competition. The FCA also assumed the FSA’s role as the UK Listing Authority.

(d) The Bank of England also took responsibility for regulating recognised clearing houses, overseeing the operation of this systemically important aspect of the financial infrastructure. The special resolution regime of the Banking Act 2009 was extended to such clearing houses.

1.6. The Financial Services Act 2012 set objectives for the Bank, the FPC, the PRA and the FCA in carrying out these responsibilities, and provided them with powers to do so. Existing powers of the FSA were reallocated, sometimes with modification, to these four bodies. The Act also dealt with the governance of these functions, and the role of the Treasury *vis à vis* the authorities. In this context, specific provision was made for mechanisms to address the perceived weaknesses noted in the former framework’s provision for crisis management. In the event of an emerging financial crisis, the Bank of England and the Treasury will have distinct but complementary roles to play, with the Bank being responsible for designing and executing most elements of the regulatory and resolution response, and the Treasury having powers controlling any decisions where there is a risk of a need to use significant amounts of public funds and where there is a serious threat to financial stability (including powers to direct the Bank of England).
1.7. The framework requires the PRA and FCA to co-ordinate their functions effectively and to co-operate with each other and with the Bank (including those functions that relate to membership of, or relations with, international bodies such as the European supervisory bodies). The Chief Executive of each sits on the Board of the other as a non-executive Director. As one of the reasons for separating the prudential and conduct regulatory functions was a perception that different a different approaches and cultures are required, the scope for conflict of the two new Regulators' objectives was contemplated. Under some circumstances, the PRA is able to veto FCA actions.

1.8. In addition to including powers for the regulation of benchmarks such as LIBOR, the Act included provision for powers to effect a transfer of consumer credit regulation from the Office of Fair Trading to the FCA. This change is to take effect from 1 April 2014.

1.9. The amendments to FSMA were extensive and necessary to reflect the replacement of the FSA by the two new Regulators. FSMA now sets out separately the responsibilities of each, making the amended statute rather repetitive though with sometimes subtle differences reflecting the different responsibilities of the two Regulators. Whole Parts of the Act were removed: Part 4, dealing with authorisation, was replaced by a new Part 4A, and Part 10, dealing with rules and guidance, was replaced with a new Part 9A. Other amendments provided greater flexibility; the existing Threshold Conditions in Schedule 6 to FSMA were made more specific, and both Regulators acquired the power to make threshold condition codes with which the Threshold Conditions must be read.

1.10. While the new institutional structure was being developed and put through the parliamentary process, the FSA had implemented its own internal transition process, moving to a shadow PRA and shadow FCA structure ready for legal cutover.

1.11. There are some analogies between the shift from the FSA to the PRA and the FCA and the creation of the FSA from its various predecessor regulators a dozen years earlier. There has been a process of grandfathering firms and their regulatory permissions and approved persons. It was also necessary, in a relatively short period of time, to create the new rule books. Echoing what happened when the FSA was established, the majority of the PRA rules will, at least initially, be largely a replication of the FSA Handbook rules. The initial creation of the PRA’s and the FCA’s rulebooks occurred through the mechanism of particular FSA rules being ‘designated’ to the PRA or FCA, or to both, reflecting each new regulator’s set of responsibilities and objectives. The rulebooks will diverge as each of the Regulators revises and amends material in accordance with its philosophy and priorities.

1.12. Little substantive change is expected to the insurance prudential rules, which will be superseded by the Solvency II requirements (see appendix H) from 1 January 2016 (assuming no further delays occur). The shift in the identity of the regulator had of itself little impact on the regulatory return.

1.13. The development of the new institutional framework in the UK was carried out against a backdrop of international developments to which the UK is committed, Solvency II being an obvious example. Another area of development, triggered by the global financial crisis, is an increased emphasis on systemic risk. The G-20 and the Financial Stability Board (FSB) now identify Global Systemically Important Financial Institutions (G-SIFIs), to which enhanced supervisory measures will be applied, in particular a requirement for higher loss absorbency by way of capital add-ons, and a requirement to extend stress testing and reverse testing requirements to encompass preparation of recovery and resolution plans (RRPs, often referred to as “living wills”). Whilst the initial emphasis was on banks, 2013 saw the designation of nine insurance groups as Global Systemically Important Insurers (G-SIIs); 2014 will see them joined by an as yet unknown number of reinsurance groups. G-SIIs were designated following assessment according to a methodology developed by the International Association of Insurance Supervisors (IAIS). In addition to RRPs, G-SIIs are required to prepare Systemic Risk Management Plans (SRMPs) and Liquidity Risk Management Plans (LRMPs). Although any capital add-ons will not apply until 2019, the nine G-SIIs are required to complete their SRMPs, LRMPs and RRPs during 2014.
Chapter 1 – Background

1.14. The debate over the potential application of RRP and capital add-on requirements to the insurance sector has been intense, and opponents fear that the insurance sector may be burdened by requirements that are inappropriate to it. Nonetheless, global attention remains on systemic risk, and it is being replicated also at regional level (the European Commission has issued a consultation paper on systemic risk within the single European markets for, inter alia, insurance) and nationally (the PRA will give consideration as to whether insurers should be required to prepare RRRPs). It is likely therefore that this policy development will in time affect domestic regulation of UK insurers.

1.15. A further IAIS project, the development of a Common Framework (ComFrame) for supervision of ‘Internationally Active Insurance Groups’ (IAIGs) proceeded further during 2013, with the publication of a consultation paper in October. The IAIS also announced in October that, as part of this project, it would develop by 2016 and then implement from 2019 a global insurance capital standard for IAIGs, providing a parallel for the insurance sector to the Basel Capital Accords. The ComFrame package includes also components relating to governance and risk management, and supervisory cooperation. The FSB encourages compliance with IAIS standards, and they are used as a benchmark for the Financial Sector Assessment Program and Report on Observance of Standards and Codes, conducted by the IMF and the World Bank. So far as concerns EEA-based groups that would fall within the IAIS’ proposed definition of IAIGs, it seems likely that the group requirements of Solvency II will substantially meet the requirements being contemplated under ComFrame. However other UK insurers may form part of IAIGs headquartered elsewhere and may be indirectly affected by the IAIS initiative.

1.16. Solvency II, the G-SII ‘package’, potential European requirements for RRP and ComFrame represent a potentially confusing plethora of supranational requirements overlaid on national ones, and it will be a challenge for national regulators and insurers to procure compliance with a minimum of duplication.

1.17. In order to avoid becoming unwieldy, and in view of the PRA being the addressee of the prudential returns prepared by insurers, this booklet will concentrate on the PRA.

2. The regulatory framework for the PRA and FCA

2.1. FSMA is drafted at an extremely high level which is intended to provide the overall framework, and much of the detail appears either in statutory instruments made by the Treasury under powers in the Act, or in the Handbook which the FSA produced under the powers conferred on it under the now repealed Part 10 of FSMA to make rules and issue guidance, and which now exists in the form of the separate PRA and FCA Handbooks. Some of the significant statutory instruments supporting FSMA are the following:

(a) The Financial Services and Markets Act (Regulated Activities) Order 2001 (2001 No. 544) (referred to as the Regulated Activities Order or RAO), specifies kinds of activities and investments for the purposes of FSMA (e.g. Schedule 1 defines the classes of insurance business). An activity of a specified kind carried on by way of business in relation to an investment of a specified kind is a “regulated activity” for the purpose of FSMA. As a result of the “general prohibition” of section 19 of FSMA, it is a criminal offence for a person who is not authorised or exempt to carry on a regulated activity in the UK. The RAO has been amended a number of times since its issue, to reflect policy decisions by the Government to specify additional regulated activities.

(b) The Financial Services and Markets Act 2000 (Communications by Auditors) Regulations 2001 (2001 No. 2587) specify the circumstances in which the auditor of an authorised firm is required to communicate information directly to the Regulators (see section 2 of chapter 9).

(c) The Financial Services and Markets Act 2000 (Control of Business Transfers) (Requirements on Applicants) Regulations 2001 (2001 No. 3625) impose certain procedural requirements on applicants for a court order sanctioning an insurance or
banking business transfer under Part 7 of FSMA. A significant number of insurance business transfers have taken place under Part 7, with a key role being played by the independent expert and increasingly (at the request of the courts) by the regulator. Further Regulations made in June 2008\(^4\) put beyond doubt the ability of the court to transfer outward reinsurance arrangements relating to the main business.


2.2. It is the PRA and FCA Handbooks to which firms will generally need to refer on a day to day basis, as these are where the rules and guidance applicable to firms are set out. The nature, structure and key content of the PRA Handbook are considered further in section 4 of this chapter. The current PRA Handbook contains extensive ‘legacy’ material inherited from the FSA and covering the areas for which the PRA now has responsibility; the PRA intends to move away over time from this legacy material and towards a PRA rulebook. Its intentions in this regard were outlined in Chapter 10 of the ‘Occasional Consultation Paper’ CP 8/13 issued in October 2013 and CP 2/14 ‘The PRA Rulebook’ issued in January 2014. The PRA intends to convert its current Handbook into a Rulebook of a different style, which will contain only rules\(^5\) and will divide the majority of rules into two sectors, being banking (i.e. deposit-takers and investment firms) and insurance. The rules will be supplemented by a limited amount of guidance in the form of ‘supervisory statements’. Progress towards this objective will continue during 2014 and will inevitably affect, if only indirectly, the preparation of PRA returns in future years. Nonetheless, reference to FCA material will at times be necessary. For example, it is the FCA website where one must go to locate the consolidated list of published waivers, even for rules that appear only in the PRA’s Handbook.

2.3. The FSA Handbook, which existed until legal cutover, represented a single compendium of rules and guidance. At legal cutover, the existing material was ‘designated’ by one or both of the PRA and FCA, under the provisions of the Financial Services Act 2012 (Transitional Provisions) (Rules and Miscellaneous Provisions) Order 2013 (SI 2013/161) (commonly referred to as the Designation Order). The principal legal instrument by which the designation was initially made was the Financial Conduct Authority and Prudential Authority Handbook Designation Instrument 2013, numbered as FCA 2013/8 and PRA 2013/3, one of a number of legal instruments made around the time of legal cutover to give effect to the changeover from one regulator to two. The material designated by each regulator formed its Handbook.

2.4. The PRA is required to determine its strategy, and therefore implicitly the rules that it makes for insurers and other financial services providers, in relation to objectives set in statute. Sections 2B and 2C of FSMA sets two regulatory objectives for the PRA; a “general objective” and an “insurance objective”.

**(a)** The general objective is promoting the safety and soundness of PRA-authorised persons. This objective is articulated primarily in terms of managing the adverse impact on the financial system of the activities or failure of such persons.

**(b)** The insurance objective is contributing to the securing of an appropriate degree of protection for those who are or may become policyholders.

**(c)** Section 2D empowers the Treasury to specify further objectives, in the event that an activity becomes a PRA-regulated activity.

**(d)** Section 2G places a limitation on the objectives, making it clear that the PRA is not required to ensure that no PRA-authorised person fails.

2.5. The FCA also has statutory objectives, set out in Part 1A of the Act. Briefly, it has a “strategic objective” of ensuring that relevant markets (defined in section 1F to include *inter alia* 4 The Financial Services and Markets Act 2000 (Amendments to Part 7) Regulations 2008 (2008 No. 1468), 5 A foretaste of the new Rulebook is now provided by the materials applicable to credit institutions and investment firms as from 1 January 2014, which has been introduced to the PRA Handbook.

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\(^5\) A foretaste of the new Rulebook is now provided by the materials applicable to credit institutions and investment firms as from 1 January 2014, which has been introduced to the PRA Handbook.
markets for regulated financial services) function well, and three “operational” objectives: securing an appropriate degree of protection for consumers (the “consumer protection objective”, under section 1C); protecting and enhancing the integrity of the UK financial system (the “integrity objective”, under section 1D); and promoting effective competition in the interests of consumers in the markets for regulated financial services and for exempt services provided by recognised investment exchanges (the “competition objective” under section 1E).

2.6. Section 2H of FSMA requires the PRA, and section 1B the FCA, to have regard to a number of factors in discharging their general functions (which are making rules, preparing and issuing codes and determining the general policy and principles by reference to which they perform particular functions, plus in the case of the FCA only, giving general guidance). Both Regulators must have regard to “Regulatory Principles” set out in section 3B:

(a) the need to use their resources in the most efficient and economic way;

(b) the principle that a burden or restriction which is imposed on a person, or on the carrying on of an activity, should be proportionate to the benefits, considered in general terms, which are expected to result from the imposition of that burden or restriction;

(c) the desirability of sustainable growth in the economy of the UK in the medium or long term;

(d) the general principle that consumers should take responsibility for their decisions;

(e) the responsibilities of the senior management of persons subject to requirements imposed by or under the Act, including those affecting consumers, in relation to compliance with those requirements;

(f) the desirability where appropriate of each regulator exercising its functions in a way that recognises differences in the nature of, and objectives of, businesses carried on by different persons subject to requirements imposed by or under the Act;

(g) the desirability in appropriate cases of each regulator publishing information relating to persons on whom requirements are imposed by or under the Act, or requiring such persons to publish information, as a means of contributing to the advancement by that regulator of its objectives; and

(h) the principle that each regulator should exercise its functions as transparently as possible.

2.7. In addition, section 2H separately requires the PRA to have regard to the need to minimise any adverse effect on competition in markets for services provided by PRA-authorised persons in carrying on regulated activities, that may result from the manner in which the PRA discharges its functions. Competition being already an operational objective of the FCA, this is not a principle for the FCA. The FCA does however under section 1A have an additional principle to observe, not shared with the PRA: the importance of taking action intended to minimise the risk of financial crime related to financial services supervised by the FCA.

2.8. Both Regulators are required to give and keep under review guidance as to how they intend to advance their objectives in discharging their general functions. Each is required to consult the other before giving or altering such guidance (section 1K for the FCA, and section 2I for the PRA). The FCA’s guidance is made as part of the “general guidance” that it is empowered to make by section 139A, similar to that used by the FSA before it. The PRA has no such “general guidance” power but is required by section 2I to publish guidance it makes relating to its objectives.

2.9. The PRA’s general approach to insurance supervision was foreshadowed in the consultations published by HM Treasury and by the FSA and the Bank of England Treasury during the period leading to the passage of the Financial Services Act 2012. It is summarised in its April
2013 publication “The Prudential Regulation Authority’s approach to insurance supervision” (a similar document deals with supervision of deposit-takers and designated investment firms). This document is not itself a statutory instrument or legal instrument, but it is indicative of policy and indeed responds to the section 2I requirement referred to in the preceding paragraph.

2.10. The PRA’s general objective, as has been described above, is to promote the stable and prudent operation of the financial system through the effective regulation of financial firms, in a way which minimises the disruption caused by any firms that do fail. Its processes and legal framework are described as designed to facilitate a judgement led style of prudential regulation. Supervisors are expected to focus more than previously on understanding institutions' business models and strategies, with greater discretion to tackle risks and vulnerabilities within individual firms. In some respects, the PRA seems likely to be similar to the FSA, at least in its desire to use judgement and perform proper analysis of evidence, but with greater emphasis on a forward-looking approach that may lead at times to actions that, with hindsight, prove to have been unnecessary.

2.11. The PRA intends to adopt a risk assessment framework with three main elements:

- Potential impact, both of the way in which an insurer carries on its activities and in the event of failure;
- How the external context in which an insurer operates and the business risks it faces affects its viability (this is referred to as the ‘risk context’); and
- The mitigating factors, operational, structural and financial.

2.12. The degree of intervention applied will depend upon the PRA’s perception of the risk that an insurer poses to its supervisory objectives (policyholder protection and system stability) and its perceived proximity to failure. The approach paper includes details of the PRA’s Proactive Intervention Framework.

2.13. The PRA’s approach is designed to deliver, in due course, the requirements of Solvency II, building on development work already carried out by the FSA in terms of internal model assessment, proposals for Own Risk and Solvency Assessment and co-operation with other competent authorities.

2.14. Although the approach to be adopted by the PRA was flagged as new, and representing a more judgemental and less “tick box” approach, these were directions in which the FSA was already moving. The expressed desire that the PRA will be able to simplify its rulebook compared to the FSA Handbook will need to pass the test of time; the need to implement European measures (to which a “copy out” approach is generally taken) may place a constraint on what is achievable in this regard. However one aspect of simplification, the planned elimination of former FSA guidance from the PRA rulebook, may result in a reduction in regulatory certainty; it may be felt that guidance fulfilled a useful function that will be missed.

2.15. In addition to the powers and responsibilities of the PRA and FCA, FSMA also covers other aspects of the architecture for financial services regulation, two of which warrant brief mention. Part 15 deals with the establishment of a single Financial Services Compensation Scheme (FSCS), which provides compensation where a firm is unable, or likely to be unable, to satisfy claims against it. FSCS is financed by levies on the relevant sector. Part 16 deals with the operations of the Financial Ombudsman Service (FOS) which is administered and operated by the Financial Ombudsman Service Limited (FOS Ltd) and which is also financed by levies imposed on regulated firms. FOS was established as an independent dispute resolution scheme to resolve complaints about financial services firms quickly and with minimum formality. Responsibility for the rules relating to FOS is shared between the FCA and FOS Ltd, with those rules written by FOS Ltd being subject to the approval of, or the consent of, the FCA.
Chapter 1 – Background

3. **Insurance supervision prior to legal cutover**

3.1. Some description of the former regime for insurance supervision is necessary, including indeed reference to the regime as it operated prior to November 2001, due to aspects of past regimes that remain relevant to PRA Returns of some insurers to this day.

3.2. The FSA was primarily responsible for the prudential and conduct supervision of the insurance industry and other financial services industry participants until legal cutover. It acquired its initial powers under FSMA at midnight on 30 November 2001 (a date commonly referred to as “N2”). The scope of FSA activity expanded during this period, as new types of regulated activity were brought under its supervision through amendment to FSMA and regulations made thereunder. The functions it exercised had previously been the responsibility of no fewer than nine bodies. The following paragraphs provide a brief history of the development of insurance prudential regulation prior to N2.

3.3. Prior to N2, the principal source of primary legislation relevant to the insurance industry was the Insurance Companies Act 1982. This primary legislation gave authority to the Regulators to prescribe the detail by making regulations. The statutory instruments made included Regulations dealing with accounts and statements, valuation and solvency requirements, equalisation provisions, auditors' responsibilities and matters relating to the Lloyd's insurance market.

3.4. The Regulators also issued guidance notes to assist insurers and their advisors in dealing with the legislation, which in 1994 became a numbered series of Prudential Guidance Notes (PGNs). The Regulator also from time to time issued market letters, which were at one time organised into a numbered “Dear Director” series. “Dear Appointed Actuary” letters issued by the Government Actuary's Department were also of significance, and some of these, together with all the extant PGNs were initially carried forward into the FSA Handbook, but were deleted in 2004.6

3.5. Section 68 of the 1982 Act enabled the Regulator, on the application of or with the consent of an insurer, to modify certain of the provisions of the legislation for that insurer. A great many section 68 Orders were issued under the 1982 Act (165 during 2000 alone), and some of these remained in force throughout the period in which the FSA was the responsible regulator, and expired only at legal cutover, a deliberate policy decision at the time.

3.6. The current PRA Returns date essentially from the Insurance Companies (Accounts and Statements) Regulations 1980, subsequently replaced in 1983 and 1996. These established the format of the return as a series of standardised interlocking forms. The bulk of the Forms have remained substantially unchanged since their introduction, though additional disclosures have been added over the years.

3.7. In addition to the requirements of FSMA, a UK-incorporated insurer has to comply with the Companies Act 2006 and will therefore need to produce at least two sets of financial statements each year: the accounts prepared primarily for its shareholders under the rules set out in Schedule 3 to the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (the insurance accounts rules) or in accordance with international accounting standards as endorsed in the EU, and the return prepared for submission to the PRA. The terms “accounts” and “return” will be used throughout this booklet to contrast the two. A non-UK incorporated insurer will need to register its branch under Part 34 of the Companies Act 2006, but will prepare accounts under the rules prescribed in its country of incorporation. Other UK reporting requirements of insurers are referred to in chapter 11 of this booklet.

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6 The FSA continued to issue broadcast “Dear CEO” letters to senior industry executives, but these were not numbered and did not form part of the Handbook although they remain accessible in the library section of the FSA website (which continues in existence though it is no longer updated).
Chapter 1 – Background

4. The PRA Handbook

4.1. The PRA has a general rule making power under section 137G of FSMA, which allows it to make such rules applying to PRA-authorised persons with respect to the carrying on by them of regulated activities (or indeed with respect to the carrying on by them of activities which are not regulated activities) as appear to it to be necessary or expedient for advancing any of its objectives. Before the PRA makes any rules, it is required by section 138J to consult with the FCA and then to publish a draft accompanied by a cost benefit analysis, an explanation of the purpose of the proposed rules, a statement (if relevant) of the differential impact of the proposed rule on mutual societies (section 138K), an explanation of the PRA's reasons for believing that making the proposed rules is compatible with its statutory objectives and with the Regulatory Principles referred to in paragraphs 2.6 and 2.7, and a notice that representations about the proposals may be made to the PRA within a specified time. The ‘Consultation Paper’ or CP (with subsequent feedback) became an established feature of the landscape under the FSA, with a total of 476 issued by the time it morphed into the FCA at legal cutover. The PRA is developing its own style for CPs.

4.2. The FCA has similar rule-making powers under section 137A of FSMA, and section 138I requires it to consult with the PRA and then publicly before rules may be made.

4.3. The FSA was also empowered by FSMA to give guidance consisting of such information and advice as it considered appropriate with respect to the operation of FSMA and of any rules made thereunder, with respect to any matters relating to functions of the FSA, for the purpose of meeting its regulatory objectives and with respect to any other matters about which it appeared to the FSA to be desirable to give information or advice. The FCA has acquired a similar power, set out in section 139A. Where the guidance represents “general guidance” (i.e. it is given in writing to persons generally, to FCA-regulated persons generally or to a class person or FCA-regulated person, the consultation provisions of section 138I apply, although it is also possible for the FCA to give individual guidance (IG). Chapter 9 of the Supervision Manual SUP in the FCA Handbook sets out the necessary process for obtaining IG.

4.4. The PRA has not acquired such a power. The status of guidance, whether general or individual, given by the FSA prior to legal cutover in relation to matters that are now the responsibility of the PRA is discussed further below.

4.5. The distinction historically between rules and guidance may be briefly summarised as follows, and remains the case so far as concerns the FCA Handbook. The Reader’s Guide: an introduction to the Handbook, a publication of the FCA and PRA, provides further background. While the legal effect of a rule varies according to the power under which it was made and the language used, most of the rules in the PRA and FCA Handbooks create binding obligations on firms. If a firm contravenes such a rule, it may be subject to enforcement action and, in certain circumstances, to an action for damages. Historically, by contrast, guidance was not binding and need not be followed in order to achieve compliance with the relevant rule, so a firm could not incur disciplinary liability merely because it had not followed guidance, nor was there any presumption that departing from guidance was indicative of a breach of the relevant rule. Guidance has typically been designed to throw light on a particular aspect of regulatory requirements, to indicate possible means of compliance or to recommend a particular course of action, and not to be an exhaustive description of firms’ responsibilities. However, if a person acted in accordance with general guidance in the circumstances contemplated by that guidance, the FSA would proceed on the footing that the person has complied with the aspects of the rule to which the guidance related. This remains explicitly the situation for guidance in the FCA Handbook, and whilst the PRA Handbook continues to use the category of guidance, it does not provide the same extensive explanation of its status. Paragraphs in most modules of both Handbooks are labelled with an “R” or “G” to make their status as rules or guidance clear.\footnote{The Handbooks also contain evidential provisions, identified by an E. These are still technically rules, but are indicative rather than binding in nature, and create rebuttable presumptions of compliance with or contravention of...}
4.6. The absence of an explicit power for the PRA to make guidance in respect of the rules that it administers is of considerable interest, given the importance of guidance in a number of situations where it clarifies the intention of rules (to take but one example, much of the material in INSPRU 7.1 on individual capital assessment). The extensive guidance in the legacy material that formed the PRA Handbook at legal cutover, together with the transitional provision referred to in the following paragraph, provide an interim solution however as the PRA makes its own rules and deletes legacy guidance material, the question will become more pressing. The PRA is, as stated earlier, still required to publish guidance on its approach.

4.7. The continuing status of general guidance is dealt with in the general transitional provisions contained in the General Provisions Sourcebook (GEN). GEN TP2 (Transitional Provisions applying across the FCA and PRA Handbooks) states at Paragraph 1 of Table 2 that, subject to context and any more specific transitional provision, “Anything done, or having effect as done, under or for the purposes of any pre-cutover provision has effect as if done under or for the purposes of any substantially similar provision in the FCA and PRA Handbooks.” Paragraph 17 of the same table makes it clear that this relates to provisions that are not rules (such as guidance), as well as rules. The text of paragraph (1) of Table 1 in GEN TP2 is admirably direct and clear: “The purpose of these transitional provisions is to assist a smooth transition at cutover. They comprise various technical provisions that will apply across the whole FCA and PRA Handbooks and achieve results that most people would probably expect to apply in any event.”

4.8. However, so far as concerned IG, the FSA had announced (in PRA Transition Update 1302 issued in February 2013) that only certain IG would be carried over automatically, the main categories relevant to insurers being Individual Capital Guidance and IG on regulatory reporting. Firms were encouraged to review their other existing IG and consider whether behaviours following from that IG would advance the PRA’s objectives. That review, which firms were expected to perform themselves, could lead firms to ask the PRA to review some areas of IG, and confirm whether behaviour reliant on that Individual Guidance would continue to be appropriate under the PRA. The FSA’s document was clear that this was not an invitation to present all IG for review. The PRA would have 18 months to complete its review, and firms could continue to rely on IG that is under review. However, any IG that had not been submitted for review by the end of September 2013 has ceased to have any status. Whether behaviours adopted by firms in the context of the IG should change as a consequence would depend on the firms’ self-assessment of that behaviour in the context of the PRA’s objectives.

4.9. Many rules in the Regulators’ Handbooks may be ‘waived’ or modified, by direction given by the relevant regulator, and many insurers have historically obtained waivers that affect their regulatory returns. The procedure for applying for and granting waivers to Handbook rules is set out in Chapter 8 of the Supervision Manual SUP. A firm must apply for a waiver in writing, and include all of the following in the application:

(a) the name and firm’s reference number\(^8\) of the firm making the application, and a contact point for the firm on the application;

(b) the reference number of the rule to which the application relates;

(c) a clear explanation of the waiver that is being applied for and the reasons why the firm wants it;

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the binding rules to which they relate. Other provisions, comprising Directions (D), directly applicable UK legislation (UK or a union flag symbol), directly applicable EU legislation (EU or a European Union flag symbol), Statements of Principle for Approved Persons (P) and (in the FCA Handbook only) circumstances tending not to indicate market abuse (C), also exist but have limited impact on the subject matter of this booklet and are therefore not considered further.

\(^8\) This can be ascertained by performing a search on the insurer’s name in the FS Register. The firm’s reference number (formerly its FSA reference number) is used by both the FCA and PRA.
(d) details of any special requirements, for example if the firm needs a decision urgently, or there is a specific period for which the waiver is required;

(e) relevant facts which support the firm’s application;

(f) the firm’s reasons for considering that the two conditions in section 138A(4) of FSMA, (which are preconditions for either regulator to grant a waiver) have been satisfied:

(i). compliance by the authorised person with the rules, or with the rules as unmodified, would be unduly burdensome or would not achieve the purpose for which the rules were made; and

(ii). the direction would not adversely affect the advancement of any of the regulator’s objectives (for the FCA, any of its operational objectives); and

(g) confirmation that the firm is content for the waiver to be published or, if not, the reasons why the firm believes that it would be inappropriate or unnecessary to publish the waiver or that the waiver should be published without disclosing the identity of the firm.

4.10. Any waiver should be applied for on a timely basis. Waivers cannot, strictly, be backdated. It is sufficient for a waiver relating to the form of return to be issued prior to the date on which the return is due to be submitted or is actually submitted, but a waiver relating to the underlying rules in GENPRU or INSPRU should be obtained prior to the end of the financial year if it is to be taken into account in preparing the return.

4.11. A standard waiver application form is provided by Annex 2D to Chapter 8 of SUP. Not only does the use of a readily recognisable form assist the appropriate regulator’s internal processing, but the format helps ensure that none of the technical requirements of SUP are overlooked. SUP 8.3.5G indicates that the appropriate regulator will aim to give waiver decisions within 20 days of receiving an application which gives sufficient information. However, considerably longer should be allowed for more complex cases, particularly where no precedent exists.

4.12. Waivers are used in some cases by the Regulators as a mechanism to control, on a case by case basis, concessions which are explicitly contemplated in the rules. Current examples of this are waivers to enable a mutual insurer to take credit for supplementary calls, and the ISPV regime (see section 6 of chapter 7). An important future function of waivers of this nature will apply following the implementation of Solvency II, to allow a firm to use an approved internal capital model in place of the prescribed standard formula.

4.13. In some circumstances the Regulators may be prepared to issue a general waiver (a “waiver by consent”) to firms in a particular category. This might arise, for example, if a regulator was planning to amend a Handbook rule, but this could not be achieved before a filing date, as a mechanism to allow affected firms to apply the proposed rule in advance of the legal instrument being made. In these circumstances, the regulator will advise firms that the waiver is available, either by contacting them individually or by publishing details. The action necessary to benefit from a waiver by consent will vary from case to case. In some instances a firm may need to do no more than print off a copy of the direction from the records, insert its name, date the direction, hold it in its records and advise the relevant regulator that it has done so. In other instances, an application to the central waivers team will be necessary. Details of the waivers by consent currently available are available on the FCA website.

4.14. 2013 has seen the elimination of some other concessions that were not technically waivers. A number of written concessions, originally granted under the pre-N2 regime, had continued in force following N2, by virtue of transitional provisions in SUP, and although many expired

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9 An insurer’s entry on the FS register includes links to all extant waivers applicable to that insurer which have been published. Expired waivers are not available, making the search for precedents somewhat harder. An index of extant waivers, arranged by the Handbook module and rule to which they relate, can be accessed on the FCA website by searching for ‘waivers’.
naturally or were specifically excluded by subsequent action, some of these ‘section 68 Orders’ remained in force up to legal cutover. However at legal cutover the relevant transitional provisions were deleted, and consequently all such concessions expired. An insurer that benefited from these in previous years would need to seek a new concession for 2013 and subsequent financial years.

4.15. The status of waivers granted by the FSA and in force at legal cutover is covered by GEN TP2; these continue in force (in the absence of any specific transitional provision) until they expire.

4.16. In some instances, the Handbook requires a firm to make a formal notification to the relevant regulator if it elects, where alternatives are available under the rules, to adopt a particular treatment. Such situations differ from a waiver in that formal consent from the regulator is not required, and this is a decision for the firm. Where such notification is required, the procedures for written notifications under SUP 15.7 need to be followed. An example is where an insurer elects to use the accounts consolidation approach when calculating the group capital adequacy position of an insurance group whose ultimate parent is outside the EEA (INSPRU 6.1.27R). Election does not always require notification (for example, in the case of the alternative valuation method for defined benefit liabilities referred to at GENPRU 1.3.10R).

4.17. The overall structure of the PRA Handbook as at 31 December 2013 is as follows. Each section has its own abbreviation (quoted below), which is used for cross-referencing purposes within the Handbook, and which will also be utilised in this booklet. The PRA has expressed an intention to replace these abbreviations in what it refers to as the Rulebook that it intends to develop.

<table>
<thead>
<tr>
<th>Block 1 – High level standards</th>
</tr>
</thead>
<tbody>
<tr>
<td>Principles for Businesses</td>
</tr>
<tr>
<td>Senior Management Arrangements, Systems and Controls</td>
</tr>
<tr>
<td>Statements of Principle and Code of Practice for Approved Persons</td>
</tr>
<tr>
<td>The Fit and Proper test for Approved Persons</td>
</tr>
<tr>
<td>Financial Stability and Market Guidance Sourcebook</td>
</tr>
<tr>
<td>General Provisions</td>
</tr>
<tr>
<td>Fees Manual</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Block 2 – Prudential standards</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interim Prudential Sourcebook for Friendly Societies</td>
</tr>
<tr>
<td>Interim Prudential Sourcebook for Insurers</td>
</tr>
<tr>
<td>Interim Prudential Sourcebook for Investment Business</td>
</tr>
<tr>
<td>General Prudential Sourcebook for Banks, Building Societies, Insurers and Investment Firms</td>
</tr>
<tr>
<td>Prudential Sourcebook for Banks, Building Societies and Investment Firms</td>
</tr>
<tr>
<td>Prudential Sourcebook for Insurers</td>
</tr>
<tr>
<td>Prudential Sourcebook for Mortgage and Home Finance Firms and Insurance Intermediaries</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Block 3 – Business Standards</th>
</tr>
</thead>
<tbody>
<tr>
<td>Conduct of Business Sourcebook</td>
</tr>
</tbody>
</table>

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10 See the next section of this chapter for a discussion of the development of the Prudential Standards block.
4.18. Certain modules, such as IPRU(INS), contain definition Chapters, but there is also a consolidated Handbook Glossary, which sets out definitions relevant throughout the Handbook.

4.19. Compared to the FSA Handbook that preceded it, the PRA Handbook omits a number of modules; these are predominantly those which relate only to firms that are not dual regulated, or to aspects of supervision of PRA-authorised persons that are the province solely of the FCA. One notable deletion is the COND (Threshold Conditions) module; whereas both the FSA and FCA Handbooks use this module to expand on the Threshold Conditions set out in Schedule 6 of FSMA, the PRA has chosen not to. As is explained below, however, the PRA is responsible for monitoring certain Threshold Conditions. They just no longer appear in its Handbook.

4.20. A number of ‘Handbook Guides’ and ‘Regulatory Guides’ have been published, which do not form part of the PRA or FCA Handbooks themselves, and can be amended without formal consultation. These include the Perimeter Guidance Manual (PERG) which contains extensive guidance on the scope of activities that fall within the purview of the FCA’s supervision and hence the need for authorisation. These Guides have mainly been inherited by the FCA. The PRA maintains its Building Society Regulatory Guide (BSOG). The Reader’s Guide remains relevant to the PRA Handbook and contains a short section dedicated to it.

4.21. Finally, the PRA Handbook as viewed online includes, from 1 January 2014, the first section of its proposed new Rulebook, this being the CRR section applicable to firms subject to the European Regulation on prudential requirements for credit institutions and investment firms. This does not apply to insurers, but represents a foretaste of the PRA’s plans for its regulatory material.

4.22. The FSA had developed a number of ‘Tailored Handbooks’ aimed at small firms. These contained only Handbook provisions relevant to the industry segment for which the Tailored Handbook in question was developed, though some common material (e.g. parts of the Regulatory Processes Block, and provisions relating to the FOS and FSCS) was not included. A firm could rely on a Tailored Handbook provided the firm satisfied a list of criteria or ‘attributes’ relating to that Tailored Handbook. However, following legal cutover the facility to produce tailored handbooks was withdrawn.

4.23. The majority of the prudential and reporting requirements for insurers are contained in IPRU(INS), GENPRU and INSPRU, which section 7 of this chapter will concentrate upon. However, an insurer should not concentrate exclusively on these sourcebooks and lose sight of important requirements elsewhere in the Handbook. Of particular significance are SYSC, PRIN and SUP. The FCA handbook, and in particular the modules dealing with conduct of business, is also key from an operational perspective, but with limited exceptions falls outside the scope of this publication.
Chapter 1 – Background

5. The High Level Standards

5.1. The high level standards block of the PRA Handbook is of relevance to all PRA-authorised firms, so it is appropriate to identify the key features. This block contains the following modules: PRIN; SYSC; APER; FIT; FINMAR; GEN; and FEES.

5.2. The combined FCA and PRA Handbooks together contain eleven Principles for Businesses, together with extensive commentary as to the scope of their detailed application. These underpin the detailed requirements set out elsewhere in the Handbook. The Principles have themselves the status of rules, and a breach of a Principle has historically regarded with particular severity. Of the eleven principles, six are applied by both the PRA and the FCA.

<table>
<thead>
<tr>
<th>Principle</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Integrity</td>
<td>A firm must conduct its business with integrity.</td>
</tr>
<tr>
<td>2 Skill, care and diligence</td>
<td>A firm must conduct its business with due skill, care and diligence.</td>
</tr>
<tr>
<td>3 Management and control</td>
<td>A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.</td>
</tr>
<tr>
<td>4 Financial prudence</td>
<td>A firm must maintain adequate financial resources.</td>
</tr>
<tr>
<td>5 Market conduct</td>
<td>A firm must observe proper standards of market conduct.</td>
</tr>
<tr>
<td>6 Customers’ interests</td>
<td>A firm must pay due regard to the interests of its customers and treat them fairly.</td>
</tr>
<tr>
<td>7 Communications with clients</td>
<td>A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading.</td>
</tr>
<tr>
<td>8 Conflicts of interest</td>
<td>A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client.</td>
</tr>
<tr>
<td>9 Customers: relationships of trust</td>
<td>A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgment.</td>
</tr>
<tr>
<td>10 Clients’ assets</td>
<td>A firm must arrange adequate protection for clients’ assets when it is responsible for them.</td>
</tr>
<tr>
<td>11 Relations with regulators</td>
<td>A firm must deal with its regulators in an open and cooperative way, and must disclose to the appropriate regulator appropriately anything relating to the firm of which that regulator would reasonably expect notice.</td>
</tr>
</tbody>
</table>

The following five Principles are applied by the FCA only:

<table>
<thead>
<tr>
<th>Principle</th>
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</tr>
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<tbody>
<tr>
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<td>A firm must arrange adequate protection for clients’ assets when it is responsible for them.</td>
</tr>
</tbody>
</table>

5.3. Principle 11 is of particular significance, as compliance with this principle can involve a considerable amount of information being supplied by an insurer to the Regulators, outside
the annual return and other formal reporting requirements. The Regulators regard compliance with Principle 11 as including but not being limited to:\(^1\)

(a) any proposed restructuring, reorganisation or business expansion which could have a significant impact on the firm’s risk profile or resources, including, but not limited to:

(i). setting up a new undertaking within a firm’s group, or a new branch (whether within the United Kingdom, or overseas);

(ii). commencing the provision of cross-border services into a new territory;

(iii). commencing the provision of a new type of product or service (whether in the United Kingdom or overseas);

(iv). ceasing to undertake a regulated activity, or ancillary activity, or significantly reducing the scope of such activities;

(v). entering into, or significantly changing, a material outsourcing arrangement;\(^2\)

(vi). a substantial change or series of changes in the governing body of an overseas firm; or

(vii). any change to the firm’s prudential category or sub-category;

(b) any significant failure in the firm’s systems or controls, including those reported to the firm by the firm’s auditor;

(c) any action which a firm proposes to take which would result in a material change in its capital adequacy or solvency, including but not limited to:

(i). any action which would result in a material change in the firm's financial resources or financial resources requirement;

(ii). a material change resulting from the payment of a special or unusual dividend or the repayment of share capital or a subordinated loan;

(iii). for firms which are subject to the rules on consolidated financial supervision, any proposal under which another group company may be considering such an action; or

(iv). significant trading or non-trading losses (whether recognised or unrecognised).

Above all, Principle 11 implies a “no surprises” regime. When the regulatory return is submitted, this should simply serve to confirm the Regulators’ understanding of the firm’s operations and financial position.

5.4. The purpose of SYSC is to encourage the directors and senior managers of a firm to take appropriate practical responsibility for their firm’s arrangements on matters likely to be of interest to the PRA because they impinge on the PRA’s functions under FSMA, to increase certainty by amplifying Principle 3 and to encourage firms to vest responsibility for effective and responsible organisation in specific directors and senior managers. The basic requirement in relation to responsibilities is that the firm must take reasonable care to maintain a clear and appropriate apportionment of significant responsibilities among its directors and senior managers in such a way that:

(a) it is clear who has which of those responsibilities

\(^1\) SUP 15.3.8G.
\(^2\) SYSC 13.9 provides guidance on outsourcing arrangements for insurance firms.
(b) the business and affairs of the firm can be adequately monitored and controlled by the directors, relevant senior managers and the governing body of the firm.

5.5. One or more individuals in the firm (normally including the chief executive) must be allocated the functions of dealing with this apportionment of responsibilities and overseeing the establishment and maintenance of systems and controls, which the next paragraph will consider. This activity itself represents a controlled function under the approved persons regime (the apportionment and oversight function). A firm must make a record of the arrangements and take reasonable care to keep this up to date. This record must be retained for six years from the date on which it was superseded by a more up-to-date record.

5.6. The SYSC material on systems and controls largely represents high level guidance designed to amplify SYSC 3.1.1R, which provides that “A firm must take reasonable care to establish and maintain such systems and controls as are appropriate to its business”. What is appropriate for a particular firm will depend upon the nature, scale and complexity of the business, the diversity of its operations (including geographical diversity), the volume and size of its transactions and the degree of risk associated with each area of operation. Some of the main issues that a firm is expected by SYSC to consider include the need for:

(a) clear and appropriate reporting lines
(b) appropriate safeguards in respect of delegation, both internally and externally (outsourcing)
(c) segregation of responsibilities
(d) compliance with applicable standards under the regulatory system and to counter the risk that the firm might be used to further financial crime
(e) depending on the nature, scale and complexity of the business, a separate risk assessment function, audit committee and internal audit function
(f) information to enable the firm’s governing body to play its part in identifying, measuring, managing and controlling risks of regulatory concern
(g) anyone acting for the firm to be suitable
(h) planning the business appropriately so that it is able to identify, measure, manage and control risks of regulatory concerns
(i) managing tensions resulting from remuneration policies
(j) business continuity.

5.7. The regulatory framework also imposes requirements on the individuals performing specific “controlled functions” for a firm, as well as the firm itself. A full description of the “Approved Persons” regime is beyond the scope of this handbook, but these functions generally include roles related to governance, significant areas of executive management or customer relation, and are not limited to employees of the firm itself. Functions are defined as FCA-controlled or PRA-controlled in the Supervision Manual. Where an individual is proposed to carry out a PRA-controlled function, pre-approval to do so (for that function and for that firm) is required from both the PRA as prudential regulator and the FCA as conduct regulator. Certain functions are also designated as FCA-controlled, and require only FCA pre-approval. Individuals so approved are referred to as “approved persons”. The approved persons regime, like much of the rest of the framework, was prior to legal cutover a single regime, and has now been divided between aspects relating to prudential supervision and aspects relating

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SYSC indicates that appropriate records might include organisational charts and diagrams, project management documents, job descriptions, committee constitutions and terms of reference provided they show a clear description of the firm’s major functions.
to conduct supervision. All approved persons are subject to the Statements of Principle in APER, which can be seen as the equivalent for individuals of the Principles for Businesses. There are two sets of Statements of Principle, for individuals performing PRA-controlled and FCA-controlled functions; at the time of writing these are closely aligned, though the two regimes are likely to diverge with time. The most noticeable difference at present is that FCA-approved persons are required to observe proper standards of market conduct.

5.8. These Statements of Principle are supplemented by a Code of Practice, which has been issued to help determine whether or not an approved person’s conduct complies with a Statement, by setting out descriptions of conduct which, in the Regulators’ opinion, do not comply. An approved person will only be in breach of a Statement of Principle where that person is personally culpable, which in part will hinge on the specific responsibilities that have been apportioned to that person under SYSC. Again, the Code of Practice and descriptions contain a number of provisions specific to one or other Regulator, often with only minor differences in wording or cross-references, as well as a number that are common to both.

5.9. GEN contains a variety of miscellaneous provisions, one of the most important of which in practical terms is that an expression which appears in italics in the Handbook is to be interpreted in accordance with the Glossary to the Handbook; an expression which is not shown in the text in italics has its natural meaning unless the context requires otherwise. Also of particular significance is GEN 2.2.1R which states “Every provision in the Handbook must be interpreted in the light of its purpose”. This provision is helpful in resolving ambiguity or lack of clarity, but it cannot be used to fly in the face of the words used in a rule – where a rule does not have the intended effect, the remedy is to seek a waiver as described in paragraph 4.9. Finally, GEN includes provisions covering the transition from the FSA to the two new Regulators.

6. Threshold conditions

6.1. Reference was made above to ‘Threshold Conditions’. These are set out in Schedule 6 to FSMA and represent the minimum conditions that a firm must satisfy, and continue to satisfy, to be given and to retain Part 4A permission. Originally a single list of conditions, following legal cutover Schedule 6 has become complex as it describes separately the conditions applicable to persons who are not PRA-authorised (Part 1B), conditions for which the FCA is responsible in relation to PRA-authorised persons (Part 1C), conditions for which the PRA is responsible in relation to insurers etc. (Part 1D), conditions for which the PRA is responsible in relation to other PRA-authorised persons (Part 1E), conditions applicable to incoming EEA firms and Treaty firms (Parts 1F and 1G respectively), and additional conditions applicable to UK branches of non-EEA insurers (Part 3). There are five basic conditions supervised by the PRA for insurance companies, which may be summarised as follows. As the Schedule 6 text for certain of these is extensive, regard should be had to the parent text.

<table>
<thead>
<tr>
<th>Par</th>
<th>Title</th>
<th>Summary (not exhaustive) description</th>
</tr>
</thead>
<tbody>
<tr>
<td>4B</td>
<td>Legal status</td>
<td>If the regulated activity of effecting or carrying out of contracts of insurance is carried on, the authorised person must be a body corporate (other than a limited liability partnership), a registered friendly society or a member of Lloyd’s.</td>
</tr>
<tr>
<td>4C</td>
<td>Location of offices</td>
<td>If the person concerned is a body corporate constituted under the law of any part of the United Kingdom, its head office and, if it has a registered office, that office, must be in the United Kingdom.</td>
</tr>
</tbody>
</table>

14 GEN 2.2.9G.

15 The condition goes on to state that if the person concerned has its head office in the United Kingdom but is not a body corporate, it must carry on business in the United Kingdom; this is not relevant to insurers as these must be bodies corporate under the preceding condition.
Chapter 1 – Background

4D Business to be conducted in a prudent manner

The business must be conducted in a prudent manner; in particular, the authorised person must have appropriate financial and non-financial resources. The paragraph identifies a number of features to be taken into account in determining appropriateness in this respect, including assets and liquidity, the nature and scale of the activities, the potential impact on financial stability of failure, and group membership.

4E Suitability

The person concerned must be a fit and proper person, relevant indicators including the extent and nature of compliance with PRA requirements and requests and the adequacy of its managers' skills, experience and probity.

4F Effective supervision

The authorised person must be capable of being effectively supervised by the PRA, relevant considerations including the nature and complexity of its business, the way it is organised, whether it is subject to consolidated supervision and the close links that it has with other persons. If a person with whom the authorised person is closely linked is subject to the laws, regulations or administrative provisions of a territory which is not an EEA State, those foreign provisions, or any deficiency in their enforcement, should not prevent the PRA's effective supervision of the authorised person.

6.2. These conditions are modified for branches of non-EEA insurers by the Financial Services and Markets Act 2000 (Variation of Threshold Conditions) Order 2001 (SI 2001/2507). This provides that the conditions at paragraphs 4D (insofar as it relates to appropriate financial resources) and 4E do not apply to a Swiss general insurer. Also, additional conditions are applied by the same instrument to an insurer with its head office outside the EEA, relating to the UK authorised representative, and home authorisation, maintenance of assets in the UK and deposits. Swiss general insurers are not required to maintain deposits.

6.3. The condition at paragraph 4B implements a requirement of what is commonly referred to as the “Post-BCCI” Directive for a firm’s head office and registered office to be in the same EEA State. Neither the Directive nor FSMA define what is meant by a firm’s “head office”. The PRA does not provide guidance, but FSA text that has been adopted by the FCA in COND indicates that while the FCA will judge each application on a case by case basis, the key issue in identifying the head office of a firm is the location of its central management and control: that is, the location of:

(a) the directors and other senior management, who make decisions relating to the firm’s central direction, and the material management decisions of the firm on a day-to-day basis; and

(b) the central administrative functions of the firm (for example, central compliance, and internal audit).

6.4. The condition at paragraph 4D goes far beyond the formulaic solvency requirements which are addressed at length in this booklet, and underpins the “pillar two” requirements considered in section 2 of chapter 3. Historically, the FSA interpreted the term ‘adequate’ as

meaning sufficient in terms of quantity, quality and availability, and ‘resources’ as including all financial resources, non-financial resources and means of managing the firm’s resources; for example, capital, provisions against liabilities, holdings of or access to cash and other liquid assets, human resources and effective means by which to manage risks.

6.5. In addition to the PRA-supervised conditions, the FCA applies conditions to insurers with in some respects parallel the PRA-supervised provisions but having regard to the operational objectives of the FCA. Paragraph 3B requires effective regulation, paragraph 3C appropriate non-financial resources—financial resources being the responsibility of the PRA—and paragraph 3D suitability. Paragraph 3D does not apply to Swiss general insurers.

6.6. The FCA also applies a further threshold condition, at paragraph 3E, requiring that an authorised person’s business model must be suitable for a person carrying on the regulated activities that it does, having regard to the FCA’s operational objectives.

6.7. The European Directive requirement for motor liability insurers to maintain a claims representative in each other EEA country was formerly a further threshold condition but is, since legal cutover, instead dealt with in ICOBS as a rule.

6.8. Either Regulator is empowered by section 137O of FSMA to issue a “threshold conditions code”, made up of rules supplementing any of the threshold conditions applicable to that Regulator and expressed to be relevant to the discharge of the Regulator’s functions. At the time of writing, neither has done so. The FCA has retained, with modifications, the FSA guidance contained in COND. This is not however part of the PRA Handbook.

7. The Prudential Sourcebooks

7.1. The Prudential block of the PRA and FCA Handbooks reflects a complex history, and still retains some aspects of the pre-N2 requirements and elements of unfulfilled intentions. The FSA oversaw a degree, but only a degree, of harmonisation between the very different approaches to supervision that were practised by the predecessor regulators. The FSA originally intended the Interim Prudential Sourcebooks for banks, insurers, friendly societies and investment firms which applied from N2 to be superseded by a single Integrated Prudential Sourcebook (PRU), organised by risk type. This never happened; PRU was indeed issued but never became comprehensive, and was replaced in 2006 by a General Prudential Sourcebook (GENPRU) containing material applying generally to insurers, banks, building societies and BIPRU investment firms, with separate dedicated sourcebooks for banks, building societies and investment firms (BIPRU) and for insurance firms, including the Society of Lloyd’s and managing agents (INSPRU). Completely independent sourcebooks exist for UCITS firms (UPRU) and for mortgage, home finance and insurance intermediary firms (MIPRU), which are outside the scope of GENPRU. The Interim Prudential Sourcebook for Banks has been completely withdrawn; IPRU(INS), IPRU(FSOC) and IPRU(INV) continue in existence though in the case of IPRU(INS) it does so in much reduced though still quite bulky form. The FCA has also issued a new sourcebook IFPRU for investment firms supervised by it.

7.2. IPRU(INS) originally combined the whole of the pre-N2 Regulations on insurance companies and prudential regulatory reporting and certain sections of the 1982 Act with a selection of PGNs and Dear Appointed Actuary letters. It was organised into three volumes with volume 1 containing rules, volume 2 Appendices and volume 3 guidance. Most of the material relating to matters other than regulatory reporting was replaced by material in PRU when that was created, or has subsequently moved elsewhere.

7.3. The rules volume now contains little apart from the financial reporting rules in Chapter 9 and the definitions in Chapter 11, together with their supporting Appendices. The structure of the volume as it now stands and the relevant chapters of this booklet are as follows.
Chapter 1 – Background

7.4. The application rule of Chapter 1 indicates that an insurer is required to comply with IPRU(INS) unless it is a friendly society (which would have to comply with IPRU(FSOC), although, as indicated in appendix G, a directive friendly society is required by IPRU(FSOC) to comply with many of the reporting requirements of IPRU(INS)) or an EEA insurer or EEA pure reinsurer qualifying for authorisation under Schedules 3 or 4 of FSMA (which is subject to home State control under the EU Directives). Only parts of Chapter 9, being Parts III (dealing with insurance statistics for European operations), and VII (specific requirements relating to the Lloyd's market), apply to the Society of Lloyd's.

7.5. Several Appendices survive in volume 2, where the numbering is based on the Chapter in volume 1 to which the material relates. The Appendices that remain are as follows.

<table>
<thead>
<tr>
<th>Appendix</th>
<th>Title</th>
</tr>
</thead>
<tbody>
<tr>
<td>9.1</td>
<td>Balance sheet and profit and loss account</td>
</tr>
<tr>
<td>9.2</td>
<td>General insurance business: Revenue account and other information</td>
</tr>
<tr>
<td>9.3</td>
<td>Long-term insurance business: Revenue account and other information</td>
</tr>
<tr>
<td>9.4</td>
<td>Abstract of valuation report</td>
</tr>
<tr>
<td>9.4A</td>
<td>Abstract of valuation report for realistic valuation</td>
</tr>
<tr>
<td>9.5</td>
<td>General insurance business – additional information on business ceded</td>
</tr>
<tr>
<td>9.6</td>
<td>Certificate by directors and report of the auditor</td>
</tr>
<tr>
<td>9.7</td>
<td>Insurance statistics: other EEA States</td>
</tr>
<tr>
<td>9.8</td>
<td>Marine mutuals: items to be disregarded, directors' certificates and auditors' reports</td>
</tr>
<tr>
<td>9.9</td>
<td>Group capital adequacy reporting form</td>
</tr>
</tbody>
</table>
Appendix | Title
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9.10 | Enhanced capital requirement
9.11 to 9.18 | Lloyd’s-related material

7.6. The guidance volume originally consisted of guidance notes based closely on the PGNs previously issued by the DTI/HM Treasury and also contained one Dear Director letter on the use of derivatives in connection with linked products and seven Dear Appointed Actuary letters. None of this survives. Most of the Handbook deals with guidance in a different way, with guidance paragraphs interleaved with rules. A few paragraphs of guidance have been added to volume 1 of IPRU(INS), while other relevant guidance is now to be found in SYSC or elsewhere (e.g., material on derivatives and quasi-derivatives in INSPRU). However, much of the detail previously available (e.g. that in relation to derivatives in the old Guidance Note 4.2) has been lost. At the time that PRU was being prepared, the FSA had been considering retaining Guidance Note 9.1 on the preparation of returns while freezing its content, but eventually concluded that this was impracticable and repealed the Guidance Note while transferring certain key elements (e.g. supplementary note references and country codes) into the Appendices of IPRU(INS). However, although Guidance Note 9.1 no longer has any official status (so that a firm is not protected if it acts in accordance with it), its text provides strong persuasive evidence of the appropriate treatment in the return for any disclosure that has not been changed by subsequent Instruments. There will therefore be occasional references in this booklet to “the repealed Guidance Note 9.1” and the courses of action that it recommends.

7.7. GENPRU and INSPRU remain in the Handbooks maintained after legal cutover, and their organisation is as follows.

**GENPRU**

**GENPRU 1 Application and general requirements**

1.1 – Application

1.2 – Adequacy of financial resources

1.3 – Valuation

1.4 – Actions for damages

1.5 – Application of GENPRU 1 to Lloyd’s

**GENPRU 2 Capital**

2.1 – Calculation of capital resources requirements

2.2 – Capital resources

2.3 – Application of GENPRU 2 to Lloyd’s

Annex 1R – Capital resources table for an insurer

Annex 2R – Capital resources table for a bank

Annex 3R – Capital resources table for a building society

Annex 4R – Capital resources table for a BIPRU investment firm deducting material holdings

Annex 5R – Capital resources table for a BIPRU investment firm deducting illiquid assets
Annex 6R – Capital resources table for a BIPRU investment firm with a waiver from consolidated supervision

Annex 7R – Admissible assets in insurance

Annex 8G – Guidance on applications for waivers relating to implicit items

**GENPRU 3 Groups**

3.1 – Cross sector groups

3.2 – Third-country groups

Annex 1R – Capital adequacy calculations for financial conglomerates

Annex 2R – Prudential rules for third country groups

Annex 3G – Guidance notes for classification of groups

Annex 4R – Financial conglomerate decision tree

**INSPRU**

**INSPRU 1 Insurance risk**

1.1 – Capital resources requirement and technical provisions for insurance business

1.2 – Mathematical reserves

1.3 – With-profits insurance capital component

1.4 – Equalisation provisions

1.5 – Internal-contagion risk

1.6 – Insurance special purpose vehicles

Annex 1G – INSPRU 1.2 (Mathematical reserves) and INSPRU 1.3 (With-profits insurance capital component)

**INSPRU 2 Credit risk**

2.1 – Credit risk in insurance

2.2 – Asset-related capital requirement

**INSPRU 3 Market risk**

3.1 – Market risk in insurance

3.2 – Derivatives in insurance

**INSPRU 4 Liquidity risk**

4.1 – Liquidity risk management

**INSPRU 5 Operational risk**

5.1 – Operational risk management

**INSPRU 6 Group risk**

6.1 – Group risk: Insurance groups
7.8. The future of the prudential provisions, and the PRA Handbook generally, is affected by two main influences: the expected implementation of Solvency II from 1 January 2016, and the intention of the PRA to change the style and structure of its Handbook (or Rulebook as it will become) as foreshadowed in the Approach document and further described in Chapter 10 of Occasional Consultation Paper 8 issued in October 2013 and CP 2/14 ‘The PRA Rulebook’ issued in January 2014. The PRA proposes to have the majority of rules divided into two sectors, banking and insurance, and within that between those firms subject to Directive requirements and those not. New naming and numbering conventions will be introduced. A section for credit institutions and investment firms subject to the 2013 European Regulation for such businesses is already in issue, and may be viewed on the PRA website. Further material is to be issued during 2014, and in 2015 a new PRA Rulebook site will be launched. It is to be hoped that, unlike the material now in issue for credit institutions and investment firms, this site will eventually follow the FSA tradition of providing full hyperlinking; the current new Rulebook text is present only in pdf form.

7.9. The text of GENPRU and INSPRU was not frozen after legal cutover, and the PRA keeps under review the material that has been designated to it. It is important for firms to remain abreast of changes. Care should be taken in this process, as divergence is already occurring in the Handbooks of the two regulators, including in Handbook modules containing text designated to both. As an example, the PRA has by Legal Instrument PRA 2013/25 (the Handbook Administration Instrument (No 2) 2013) deleted from its Handbook the rule (INSPRU 1.5.33R) forbidding payment of regulatory penalties from a long-term insurance fund of a proprietary insurance company. However the rule remains in the FCA Handbook.

Chapter 2 – Introduction to the Accounts and Statements Rules

The body of this booklet now concentrates on the reporting rules currently in force for insurers.

1. The development of regulatory reporting for insurers

1.1. The current return derives from a series of evolutionary changes to the set of reporting Forms introduced in 1980, changing over the years since their first introduction in response to four main drivers for change, not it is true totally independent of each other but providing a convenient framework for brief discussion:

(a) external factors such as new European Directives or accounting standards, or practices in the market

(b) the need to keep the reporting rules in line with the underlying prudential rules

(c) pure reporting considerations (i.e. the need for the regulator to receive particular types of information to fulfil its functions effectively)

(d) the correction of errors and anomalies that have crept into the rules.

1.2. European Directives have to be implemented in the United Kingdom whether the UK authorities agree with them or not. In some cases, the Directives offer member State options, or set minimum standards, and there may therefore need to be a consultation process to decide exactly how implementation will occur. However, under the “Lamfalussy” process now used for financial services directives, the basic (“framework” or “level 1”) Directives are becoming more high level and are supported by detailed implementation measures (referred to as “level 2” measures) developed at European level which have automatic effect in member States and therefore leave the Regulators with little more to do than to effect an intelligent copy out of the relevant text and insert it in the Handbook; this will be the case with Solvency II. Member State options are limited in “maximum harmonisation” Directives of this nature. Further consistency will be provided by the development of “level 3” measures developed by EIOPA for the guidance of member State supervisors.

1.3. Current prudential regulatory requirements for insurers include the requirements, together with UK enhancements, of the existing “minimum harmonisation” Directives including in particular the First, Second and Third Non-Life Directives, the Consolidated Life Assurance Directive, the post-BCCI Directive, the Solvency I Directives and the Reinsurance Directive, as well as the Insurance Groups Directive and Financial Groups Directive (as amended). Group reporting requirements of the two last are considered in chapter 10.


1.4. The Solvency II Directive represents a fundamental review of the capital adequacy regime for European insurers and reinsurers. As discussed in appendix H, the originally planned implementation date of October 2012 has been delayed until the commencement of 2016. When implemented this Directive will have radical implications for regulatory reporting, as unlike the earlier Directives it includes provision for regulatory reporting on a consistent basis across all member states.

1.5. Accounting standards drive the capital and profits that are reported in published accounts. Their relevance for regulation hinges upon the extent to which the regulatory rules follow GAAP or prescribe a particular treatment regardless of GAAP. In the UK there has been a long term trend towards the greater alignment of GAAP and regulatory treatments, and the “general GAAP presumption” of GENPRU 1.3.4R provides that assets, liabilities, income statements and equity items are to be recognised, valued and classified in line with GAAP unless there is an explicit regulatory rule in GENPRU, INSPRU or BIPRU to the contrary.

1.6. There are, of course, some situations where the rules do provide otherwise, and whenever a change occurs to accounting standards the Regulator needs to decide whether the effect of the change should be allowed to flow through to regulatory capital or whether the rules should make specific provision. Specific rules exist in relation to the treatment of defined benefit pension scheme assets and liabilities (see chapter 5 paragraph 2.15), and provisions on fair value include a requirement to consider a need for valuation adjustments. It is clear that the PRA expects valuations to be more prudent in some cases than accounting standards might prescribe (GENPRU 1.3.16R has long required market values to be based on the lower of bid and offer, not on mid-market). The PRA has in 2013 indicated concern that the insurance sector may be making inadequate provision for valuation uncertainty and has initiated a thematic review of this area, with large insurers requested to submit detailed valuation information.

1.7. In some other areas where accounting practice for insurers has changed, the rules have failed to keep pace, with the result that some anomalies persist. In particular it is unclear how the PRA expects exchange differences in general insurance business to be dealt with, in the context of a set of Forms that worked well when the norm was for revenue transactions to be accounted for at the closing rate but which have not been amended to keep pace with developing GAAP. Neither do the Forms indicate clearly how items of other comprehensive income should be dealt with.

1.8. The prudential and reporting rules are physically segregated in the PRA Handbook, and in general the prudential requirements are drawn up without explicit cross-reference to the reporting rules. For example the “business amount”, which is a concept relevant to assets discussed in chapter 4, is articulated by reference to technical provisions, other liabilities, capital resources after deduction, etc. instead of cross-referring to the relevant lines in the return where the required figures are to be found. However, the prudential rules impact directly on the reporting requirements, as they often determine how the figures reported in the return are to be arrived at. When there is a change in the underlying prudential rules, an issue therefore arises of the extent to which this necessitates mirror changes in the reporting rules.

1.9. In some cases, change may be simply cosmetic, requiring amendment to cross-references to rules. Sometimes more radical change is needed. When the concept of tiers of capital and the capital resources table were introduced for insurers, completely new Forms 1, 2 and 3

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22 Directive 98/78/EC of the European Parliament and of the Council of 27 October 1998 on the supplementary supervision of insurance and reinsurance undertakings in an insurance or reinsurance group (the original title was amended by the Reinsurance Directive by the addition of references to “reinsurance undertakings” and “reinsurance group”. This Directive is often referred to by the abbreviation “IGD”.

had to be developed to reflect this in the return, replacing previously existing Forms (see chapter 3 section 2). The need for a realistic basis life firm to calculate a with-profits insurance capital component led to the introduction of Forms 18 and 19 and the Appendix 9.4A realistic valuation report (see chapter 8 section 6).

1.10. A regulator will periodically review the type of information that it receives in the regulatory return, and propose changes. Both incremental and more wide-ranging changes have occurred in the past for insurers, but no further radical change is expected given the proximity of Solvency II and the complete revision of reporting requirements that it will entail. 2013 has seen only necessary technical amendments to the Forms themselves to reflect legal cutover, but the PRA has acted to permit solely electronic lodgement and to reduce the volume of hard copy returns that firms submitting manually must provide.²⁴

2. **Overview of structure**

2.1. The term “Accounts and Statements Rules” is defined by Chapter 11 of IPRU(INS) as “rules 9.1 to 9.36E and rule 9.39 of Chapter 9” and therefore covers Parts I, II and IV of that Chapter and the Appendices thereto rather than the Chapter as a whole. Part III (rules 9.37 and 9.38) deals with a completely separate filing requirement (statistical Forms required in respect of European operations) and will be considered in chapter 11 of this booklet, as will the material connected party transactions disclosures required by Part IV (rule 9.39), although the latter impacts on the annual return since the prescribed disclosures have to be made as supplementary notes to Form 20 or 40 as appropriate. Part V deals with the group capital adequacy report considered in chapter 10, Part VI with the reporting of the general insurance enhanced capital requirement considered in chapter 11 and Part VII with Lloyd's.

2.2. The Accounts and Statements Rules combine, but do not properly integrate, material that had, before N2, appeared in two different places, once in a high level and once in a detailed form, resulting in a structure that is unnecessarily cumbersome. There seems no compelling reason why, for example, there should be a rule 9.3 requiring the preparation of a revenue account, balance sheet and profit and loss account and separate rules defining the form that the revenue account, balance sheet and profit and loss account should take, instead of a single rule requiring specific Forms to be prepared.

2.3. Rule 9.6 will serve as a starting point for consideration of the provisions relating to the return. Following amendments made in 2013 by Legal Instrument PRA 2013/28, this requires either a hard copy (or a copy in an electronic format which may be readily used or translated by the PRA, together with a further copy in pdf form) of the following documents to be deposited with the PRA within the prescribed deadline:

(a) the revenue account, balance sheet, profit and loss account (or income and expenditure account in the case of an insurer not trading for profit) required by rule 9.3 together with the annexed notes, statements, reports and certificate (or the abridged equivalent permitted for a marine mutual under rule 9.36A);

(b) the abstract of the actuarial investigation into the financial condition of the long-term insurance business (and in the case of a realistic basis life firm, a calculation of the with-profits insurance capital component) under rule 9.4; and

(c) any report of the auditor of the insurer made in pursuance of rule 9.5 or 9.36E.

2.4. The documents other than the auditor’s report must be signed by the prescribed persons, and the auditor’s report must be signed by the auditor (rule 9.33). Rule 9.6(6) requires the deposit also (either as a hard copy or electronically, but in the latter case separately from the return itself) of a copy of any report on the affairs of the insurer submitted to its shareholders or policyholders, or to its with-profits policyholders under COBS 20.4.7R or SUP 4.3.16AR(4), in respect of the financial year.

²⁴ The Prudential Reporting Requirements for Insurers (Amendment) Instrument 2013 (Legal Instrument PRA 2013/28).
2.5. The text of the Accounts and Statements Rules takes up a mere 33 pages of volume 1 of IPRU(INS) but the related Appendices in volume 2 run to well over 200 pages. It is the Appendices that set out the many Forms that have to be completed and Instructions for their completion. In the following table, the titles of Appendices 9.1 to 9.6 are set out with an indication of the Forms which they contain and the rules which specify when particular Forms are necessary. Not every insurer will need to submit every Form. The different considerations relating to particular insurers are discussed in detail in the next section, but in broad terms a general insurer will submit the information required by Appendices 9.1, 9.2, 9.5 and 9.6, and a life insurer will submit the information required by Appendices 9.1, 9.3, 9.4, 9.4A (if it is a realistic basis life firm) and 9.6. Special provisions apply to marine mutuals, which can submit an abridged return and adopt Appendix 9.8: these are considered in appendix F to this booklet.

<table>
<thead>
<tr>
<th>Appendix</th>
<th>Title</th>
<th>Forms</th>
<th>Rules</th>
</tr>
</thead>
<tbody>
<tr>
<td>Appendix 9.1</td>
<td>Balance sheet and profit and loss account</td>
<td>1 to 3 and 10 to 19</td>
<td>9.12 and 9.13</td>
</tr>
<tr>
<td>Appendix 9.2</td>
<td>General business; revenue account and additional information</td>
<td>20A, 20 to 32, 34 and 36 to 39</td>
<td>9.14 to 9.15, 9.17 and 9.19 to 9.22</td>
</tr>
<tr>
<td>Appendix 9.3</td>
<td>Long-term business; revenue account and additional information</td>
<td>40 to 60</td>
<td>9.14 and 9.23</td>
</tr>
<tr>
<td>Appendix 9.4</td>
<td>Abstract of valuation report</td>
<td></td>
<td>9.4 and 9.31(a)</td>
</tr>
<tr>
<td>Appendix 9.4A</td>
<td>Abstract of valuation report for realistic valuation</td>
<td></td>
<td>9.4 and 9.31(b)</td>
</tr>
<tr>
<td>Appendix 9.5</td>
<td>General insurance business: additional information on business ceded</td>
<td></td>
<td>9.32</td>
</tr>
<tr>
<td>Appendix 9.6</td>
<td>Part I Certificate by directors</td>
<td></td>
<td>9.34</td>
</tr>
<tr>
<td>Appendix 9.6</td>
<td>Part II Auditor’s report</td>
<td></td>
<td>9.35</td>
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</table>

2.6. A number of the rules in the Accounts and Statements Rules do not immediately tie in to Appendices 9.1 to 9.6. The purposes of these\(^{25}\) are as follows:

<table>
<thead>
<tr>
<th>Rule</th>
<th>Purpose</th>
</tr>
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<tbody>
<tr>
<td>9.1</td>
<td>Application, stating which insurers the Accounts and Statements Rules apply to (effectively all insurers subject to IPRU(INS), although business carried on outside the UK is excluded in the case of EEA deposit insurers and Swiss general insurers).</td>
</tr>
<tr>
<td>9.2</td>
<td>Interpretation.</td>
</tr>
<tr>
<td>9.3</td>
<td>Annual accounts and balance sheet. This rule contains the general requirement for the preparation of a revenue account, balance sheet and profit and loss account and for these and annexed notes, statements, reports and certificates to be in the prescribed form. It also requires an insurer’s financial year to be a 12 month period (although this can be changed by waiver).</td>
</tr>
<tr>
<td>9.3A</td>
<td>Obligation on a realistic basis life firm to prepare Forms 2, 18 and 19 as at the end of the first six months of the financial year and submit these to the PRA together with an explanation of any changes in the methods and assumptions used from those in the investigation at the end of the previous financial year.</td>
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</tbody>
</table>

\(^{25}\) Rules 9.8, 9.9, 9.16 and 9.18 have been repealed so appear neither in this table nor in the following list.
9.6 Deposit of accounts with the PRA, including form of submission, filing deadlines and resubmission of documents.

9.7 Obligation on the insurer to provide a copy of the rule 9.6 documents to any person requesting these.

9.10 Value of assets and amount of liabilities, stating the principles to be used. This is mainly relevant to Forms 13 to 15 and is discussed in chapters 4 and 5.

9.11 This requires that the part of the return furnished pursuant to rule 9.3 shall be prepared in the manner specified and “shall fairly state the information provided on the basis required by the Accounts and Statements Rules”. The implications of this requirement, which relates to the whole of the return except Appendix 9.4 and Appendix 9.4A (which are prepared by virtue of rule 9.4), and the auditor’s report (rule 9.35), are discussed in chapter 9.

9.24 This requires Forms 20A, 21 to 32, 34, 36 to 39 and 41 to 60 to be annexed to Forms 1 to 3, 10 to 19, 20 and 40, which represent the basic balance sheet, profit and loss account and revenue account required by rule 9.3.

9.25 to 9.27 These require statements that identify and give prescribed information about major general insurance business reinsurers and cedants. A full discussion of this topic can be found in sections 4 and 5 of chapter 7.

9.28 This sets out supplementary provisions relating to the rule 9.25, 9.26 and 9.27 statements.

9.29 This requires a statement giving additional information on derivative contracts. Derivatives are discussed in section 5 of chapter 4.

9.30 This requires an insurer with its head office in the United Kingdom to prepare a statement giving information on its controllers. This statement is discussed in section 2 of chapter 11.

9.32A This requires a general insurer to prepare a statement giving additional information on financial reinsurance and financing arrangements. This statement is discussed in section 3 of chapter 7.

9.32B This provides guidance on the completion of the rule 9.32A statement.

9.33 This prescribes the signatories to the return and is discussed in section 4 of this chapter.

9.36 This requires a statement of information concerning the interests and remuneration of the actuary appointed to perform the with-profits actuary function to be annexed to the return. Section 3 of chapter 8 discusses the statement.

9.36A-E These deal with the special abridged return that a marine mutual can submit (see appendix F to this booklet).

9.39 This deals with material connected party transactions (see section 1 of chapter 11).

2.7 The Forms prescribed generally follow a pyramid principle: that is to say there are summary Forms to provide an overview, with supporting Forms breaking down the information in greater detail. There are no Forms 4 to 9, 33 or 35.

2.8 As will be seen from the discussion so far, the return does not consist only of the prescribed Forms. In addition there will be:

(a) information on general insurance business reinsurance ceded
(b) additional information on financial reinsurance and financing arrangements (general insurers)

(c) statements of major treaty reinsurers and cedants and facultative reinsurers (general insurers)

(d) a statement of additional information on derivative contracts

(e) a statement of information on controllers (United Kingdom insurers only)

(f) a statement of information about the actuary appointed to perform the with-profits actuarial function (life insurers writing with-profits business)

(g) the narrative required by Appendix 9.4 (life insurers)

(h) the narrative required by Appendix 9.4A (realistic reporting life firms)

(i) supplementary notes to the return to amplify the information given on the Forms

(j) the directors’ certificate and auditor’s report required by Appendix 9.6.

This adds up to a considerable mass of information, and the return for a major composite can run to hundreds of pages in length.

2.9. Reference was made in the previous chapter to waivers, which insurers may obtain under section 138A (prior to legal cutover, section 148) of FSMA to waive or modify rules within the PRA Handbook. Various types of waiver will impact on the annual return. The main examples of these are:

► A waiver modifying the provisions of the Accounts and Statements Rules for an individual insurer. It will normally be a requirement to include a supplementary note to the return (code 0101 or 0201) explaining the effect of the waiver. Examples include one-off modifications permitting changes in the accounting date (the rules as written require a 12-month financial year), and waivers permitting a non-EEA direct insurer to prepare an abridged global return.

► Some groups of general insurers have waivers enabling the submission of a single consolidated return in respect of general insurance business. It would normally be necessary for each insurer to cross-guarantee the others’ liabilities before such a waiver would be granted. The standard waiver that is issued in these circumstances requires an additional supplementary note giving details of the figures that would have appeared on Forms 1, 3, 11 and 12 had these been prepared for each individual insurer covered by the waiver; this is a logical approach since each insurer remains subject to an individual capital resources requirement.

► A waiver modifying rules relating to the valuation of assets will impact on the figures appearing on Form 13 and a further supplementary note (which it would be logical to reference as 1321) would often be desirable to explain the impact, as well as the note coded 0101 or 0201 referred to in the first bullet point above.

► A waiver enabling an implicit item to be included on Form 3 as counting towards the long-term insurance business capital resources requirement will need to be explained in supplementary note 0312.

In many cases a waiver will prescribe the wording to be used in the note, and may require specific additional information to be disclosed in the return.

2.10. The previous chapter also referred to waivers by consent. The Regulators have on occasion used this route to provide a concession to the market pending changes to the rules. The most significant waiver by consent that is of ongoing relevance enables an insurer in run-off to omit
Forms 26 to 29, 31, 32 and 34 from its return (chapter 6 paragraph 2.11). The FSA also announced that firms affected by the decision not to carry over pre-N2 concessions could seek a waiver by consent to obviate the impact.

3. **Classification of insurers**

3.1. There are four important factors that determine the information which an insurer is required to include in its return:

(a) whether its Part 4A permission relates to general insurance business or long-term insurance business or both;

(b) which classes of business the permission extends to;

(c) whether the business conducted in the United Kingdom is restricted to reinsurance business; and

(d) where the head office is situated.

3.2. If an insurer is only permitted to transact general insurance business, it will not furnish information under Appendices 9.3, 9.4 and 9.4A and also does not have to prepare Forms 2, 14, 18 and 19 and the rule 9.36 statement of information about the actuary appointed to perform the with-profits actuary function. If, on the other hand, an insurer is only permitted to transact long-term insurance (i.e. life) business, Appendices 9.2 and 9.5 and the statements under rules 9.25, 9.26, 9.27 and 9.32A cease to be relevant. European Directives prohibit the authorisation of insurers to carry on both general and long term insurance business, the only exceptions being where the business is restricted to reinsurance or where the only general insurance business is classes 1 (accident) and 2 (sickness). However, existing composites with more extensive permissions may continue to trade as such (and may even have their permissions extended) and therefore have a particularly extensive return to make.

3.3. An insurer’s Part 4A permission is formulated in terms of “regulated activities” (of which effecting contracts of insurance, carrying out contracts of insurance and accepting deposits are most likely to be relevant\textsuperscript{26}) and the “investment types” in respect of which they may act. Regulated activities and investment types are both defined in the Regulated Activities Order. There are nine investment types for long-term insurance business and eighteen investment types for general insurance business, both of which are derived from the classes of insurance business defined in European Directives. IPRU(INS) avoids the use of the term “investment types” but defines in Annexes 11.1 and 11.2 classes of long-term and general insurance business in precisely the same terms as the definitions of the corresponding investment types in the Regulated Activities Order. This booklet will follow the IPRU(INS) terminology and refer to “classes” rather than “investment types” as this is felt to be less open to confusion. The defined classes are as follows:

**Long-term insurance business**

I  Life and annuity

II  Marriage or the formation of a civil partnership and birth

III  Linked long-term

\textsuperscript{26} The present requirement is contained in Directive 2002/83 of the European Parliament and Council of 5 November 2002 concerning life assurance. It is preserved in the Solvency II Directive. In the Handbook, the requirement is described as FCA and PRA policy by INSPRU 1.5.17G.

\textsuperscript{27} Many insurers also hold permission for the regulated activities of entering into contractually based investments as principal and agreeing to carry out a regulated activity, mainly in order to be able to invest in derivatives. Intermediation activities (advising, arranging and making arrangements) are also widely relevant. Finally, the investment element of many life insurance contracts means that most insurers carrying on long-term business are deemed to be conducting “designated investment business”, and therefore require permission for a number of additional regulated activities.
IV Permanent health
V Tontines
VI Capital redemption
VII Pension fund management
VIII Collective insurance
IX Social insurance

**General insurance business**
1 Accident
2 Sickness
3 Land vehicles
4 Railway rolling stock
5 Aircraft
6 Ships
7 Goods in transit
8 Fire and natural forces
9 Damage to property
10 Motor vehicle liability
11 Aircraft liability
12 Liability for ships
13 General liability
14 Credit
15 Suretyship
16 Miscellaneous financial loss
17 Legal expenses
18 Assistance

3.4. In the case of general insurance business, Annex 11.3 of IPRU(INS) defines risk categories for reporting purposes by reference to the underlying eighteen classes; if business falling within a particular risk category (or combined category into which a number of risk categories are aggregated) is not carried on then Forms for that category would not need to be completed. Under rule 11.8(b) of IPRU(INS) a contract of insurance whose principal risk falls within any of general insurance classes 1 to 18 is to be treated as falling within that class and no other, notwithstanding the fact that it also covers ancillary risks. An ancillary risk is a risk within another general insurance business class which is connected with the principal risk, is concerned with the object which is covered against the principal risk, and is the subject of the
same contract insuring the principal risk. Risks in classes 14, 15 and, with certain exceptions, 17 cannot be treated as ancillary.

3.5. In the case of general insurance business, paragraph 21 of Appendix 9.2 requires an insurer that has effected no new contracts of insurance of any one or more classes of general insurance business during the financial year to state in a supplementary note to Form 20A (code 20Aj) the date on which the last new contract of each such class was effected. Such a note could act as a trigger for the PRA to challenge whether the insurer should retain its Part 4A permission to effect contracts of insurance in respect of the class in question. While the wording of paragraph 21 does not say so, it is implicit that this disclosure requirement applies only to classes for which the insurer holds permission. This supplementary note will need to be repeated in each subsequent return for as long as the situation remains unchanged.

3.6. Part 4A permission in respect of effecting or carrying out contracts of insurance can be subject to a restriction that all insurance business is restricted to reinsurance business; if the permission is not so restricted, then the insurer concerned may carry on both direct business and reinsurance business. The Handbook glossary defines a “pure reinsurer” as “an insurer whose insurance business is restricted to reinsurance.” This is not quite the same as an insurer whose Part 4A permission is restricted to reinsurance, since an insurer without such a restriction but which only in practice effected and carried out reinsurance contracts would be within the definition. In addition, IPRU(INS) refers in a number of places to non-EEA insurers “whose insurance business in the United Kingdom is restricted to reinsurance”, so a non-EEA firm which undertook reinsurance business only in the United Kingdom but wrote direct insurance business elsewhere would be treated as a pure reinsurer for reporting purposes. Neither the glossary nor IPRU(INS) defines a term to denote insurers other than pure reinsurers; the phrase “direct insurer” will be used in this booklet.

3.7. Special rules apply to pure reinsurers whose head office is outside the EEA, mainly because not all States have historically exercised supervision over reinsurers, and the UK Regulators have therefore concerned themselves with any such firm’s affairs worldwide and required a non-EEA pure reinsurer, wherever its head office may be situated, to prepare a global return in the same way as a UK incorporated pure reinsurer. EEA reinsurers are subject to a principle of home country supervision analogous to that applicable to direct insurers as described in the next paragraph, due to the operation of the Reinsurance Directive.

3.8. There are significantly different requirements imposed upon direct insurers depending upon whether their head offices are situated:

(a) in the United Kingdom (“a UK direct insurer”);  
(b) in an EEA State other than the United Kingdom (“an EEA direct insurer”);  
(c) in the case of general business in Switzerland (“a Swiss general insurer”); or  
(d) outside the EEA (“an external direct insurer”).

3.9. A United Kingdom insurer (whether direct insurer or pure reinsurer) must make a return of its world-wide business (a “global return”). The same applies to any non-EEA pure reinsurer. However, by virtue of the principle of home country supervision enshrined in the Third Non-Life Insurance Directives and the Consolidated Life Assurance Directive, EEA direct insurers are exempt from the provisions of IPRU(INS) and many of the requirements of GENPRU and INSPRU, and do not have to submit returns to the PRA at all.

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28 This term encompasses the category of ‘mixed insurer’, which is an insurer that writes both direct and reinsurance business, with the reinsurance constituting more than a prescribed threshold.
29 The Handbook glossary uses the term “UK insurer” to refer to an insurer, other than a pure reinsurer or a non-directive insurer, whose head office is in the United Kingdom. In order to avoid confusion, this booklet will use the longer term “UK direct insurer” for such entities and “United Kingdom insurer” for any insurer (whether direct insurer or pure reinsurer) with its head office in the United Kingdom.
3.10. Among direct insurers located outside the EEA, there is a special regime applicable to Swiss general (direct) insurers as a result of an agreement between the EEA and Switzerland. The differences in the treatment applied to Swiss general insurers and external direct insurers are as follows:

► A Swiss general insurer only makes a return of the business carried on by it through a branch in the United Kingdom (a “UK branch return”). UK capital requirements do not apply to such an insurer and it therefore does not complete Forms 1, 11 and 12.

► An external direct insurer is required to prepare both a UK branch return (which in contrast to a Swiss general insurer does include Forms 1, 11 and 12 to demonstrate that a UK minimum capital requirement has been complied with) and a global return. In the UK branch return it must include additional Forms 13 to demonstrate compliance with particular deposit and localisation requirements.

► The concept of capital resources is only applicable to a global return. Consequently in a UK branch return an insurer will not prepare Form 3, but will prepare Form 10 (that was at one time required of all insurers, before the introduction of Form 3).

3.11. The position may be summed up by the following table:

<table>
<thead>
<tr>
<th>Incorporation</th>
<th>Direct insurer</th>
<th>Pure reinsurer</th>
</tr>
</thead>
<tbody>
<tr>
<td>United Kingdom</td>
<td>Global return</td>
<td>Global return</td>
</tr>
<tr>
<td>Elsewhere in EEA</td>
<td>No return</td>
<td>No return</td>
</tr>
<tr>
<td>Switzerland (general insurance)</td>
<td>UK branch return</td>
<td>Global return</td>
</tr>
<tr>
<td>Outside the EEA</td>
<td>Global return and UK branch return</td>
<td>Global return</td>
</tr>
</tbody>
</table>

3.12. The EU Directives require EEA States to enact legislation enabling the main supervision of a non-EEA direct insurer carrying on business in several EEA States to take place in one of the States concerned. A deposit need only be made in the main supervisory State; the remaining States treat the insurer in much the same way as a Swiss general insurer. An insurer making use of these provisions is referred to as a UK-deposit insurer where the PRA exercises this main supervision, and as an EEA-deposit insurer where the authorities of another EEA State do so. A UK-deposit insurer must submit an EEA branch return, rather than a UK branch return and satisfy an EEA minimum capital requirement rather than a UK minimum capital requirement, but is otherwise treated as a normal external direct insurer. As there are very few UK-deposit and EEA-deposit insurers at the date of writing, these have been ignored in the main text of this booklet, although appendix E sets out the considerations relating to the returns of such insurers.

4. General points on Form completion

4.1. Reference has already been made to the many Forms set out in Appendices 9.1 to 9.3 which will make up the bulk of an insurer’s return. There is no obligation to use the blank Forms reproduced from IPRU(INS) and very few insurers do so: the overwhelming majority use a recognised commercial software package30 (such as FSAssist or BestESP Services) that produces substitute Forms, or their own bespoke software application. If an insurer chooses to print its own Forms, it should adhere rigidly to the layout of each Form within IPRU(INS). The Instructions to the Forms need not, however, be reproduced in the return.

4.2. The Forms contain heading information that falls into two parts. There is first of all a narrative heading with the Form number on the right, and on the left:

30 The use of a package in no way restricts the insurer’s responsibility for ensuring that the return is correct.
(a) the title of the Form;
(b) the name of the insurer (which should be the full registered name without abbreviation);
(c) Global business/UK branch business/EEA branch business (two of which need to be deleted); and
(d) financial year ended (to be set out in a day/month/year style).

4.3. Particular Forms require additional information where some subdivision of the business is being dealt with (e.g. reporting category, currency or reporting territory).

4.4. This narrative information is then reproduced in a computer coding heading box where numbers are used to denote reporting category and financial year end (where there is a month box, a two-digit number should be used, with leading zeros where necessary), GL, UK, CM to denote global, UK branch or EEA branch return, letters to denote currency, etc. The insurer is identified by a registration number, which will normally be the full registration number allocated by the appropriate Registrar of Companies. An insurer without such a number should agree a suitable number with its supervisor. An overseas insurer must use its place of business (F prefix) number rather than its branch (BR prefix) number. Since 2005, the life-specific Forms – 14, 18, 19 and 40 to 60 – no longer have such computer headings.

4.5. Considerations of good presentation suggest that it would be appropriate for insurers to adopt a similar convention to that of the Form headings when preparing information under Appendices 9.4, 9.4A, 9.5 or 9.6 or rules 9.25, 9.26, 9.27, 9.29, 9.30, 9.32A and 9.36, to make the nature of the document immediately apparent to the reader. Thus the Appendix 9.6 Part I certificate would be headed, not by just the (potentially inaccurate) “directors’ certificate”, but as:

Certificate required by rule 9.34(1) of the Accounts and Statements Rules
Example Insurance plc
Global business
Financial year ended 31 December 2013

4.6. The main sources of information for the body of the Forms are as follows:
(a) In many cases the narrative rubric to a particular line will be self-explanatory (e.g. share premium account on Form 3).
(b) Part 1 of Chapter 11 contains precise definitions of a number of terms appearing on the Forms (e.g. claims management costs).
(c) Part 2 of Chapter 11 provides that where a word or phrase which is printed in italics is not given a meaning in Part 1, that word or phrase has the meaning to it given in the general Handbook glossary.
(d) Rule 9.2(1) provides that unless the context requires otherwise, words and expressions that are not defined in IPRU(INS) shall have the same meaning as in the insurance accounts rules.
(e) Best practice for the purposes of the Schedule 3 accounts is to a large extent defined by the Statement of Recommended Practice (“SORP”) on accounting for insurance business issued by the ABI. The current version of the ABI SORP is dated December 2005 (revised December 2006). The ABI SORP is also relevant in indicating accounting policies for UK insurers preparing accounts under IFRS, in view of the transitional nature of the current version of IFRS 4 on insurance contracts.
(f) Within the Appendices there are written instructions both in the body of the Appendix and attaching to specific Forms (these latter are referred to in this booklet as ‘Instructions’).

(g) Guidance Note 9.1, although repealed, can be regarded as indicative of best practice in areas where the requirements have not been changed.

4.7. Some Forms at one time included a source column indicating from which line and column of which other Form a figure is to be derived, though since 2005 this has been replaced by narrative Instructions. However the source column established a useful convention, which this booklet will continue to use, whereby (e.g.) “21.19.5” is used as shorthand for Form 21, line 19, column 5.

4.8. Chapter 4 of the repealed Guidance Note 9.1 indicated certain conventions for completing the Forms. The FSA preferred typewritten entries to hand-written ones, but indicated that there should be no more than 5 characters per centimetre or 12 per inch. Where a long (i.e. more than 3 digit) figure has to appear, this may be included without punctuation or with commas but not with full stops. Negative figures (or strictly speaking negative figures on a line where positive figures would normally be expected such as line 31 of Form 16) are to be indicated by the use of brackets and not by a minus sign or the abbreviation DR (this particular convention is a requirement of paragraph 6 of Appendix 9.1). Where amounts due to and from the same person are netted, a positive figure should be shown on an asset form rather than a negative figure on a liability form (and vice versa).

4.9. If there can never be an entry in a particular cell because of the nature of the item (e.g. 23.11.7 and 23.11.8 since there cannot be reported outstanding claims and IBNR brought forward in respect of the accident year corresponding to the financial year) then the space will have been shaded on the blank Form. An insurer should not attempt to make an entry here or in any unused line or column on Forms 23, 26 to 29, 31, 32 or 34 after the last accident year or underwriting year required to be reported. In other cases where there is no figure to report (including where a number has been rounded down to zero) the cell must be left blank. “0”, “-” and “nil” are not to be used.

4.10. The return is completed in sterling, with the exception of Forms 26 to 29, 31, 32 and 34 which are required to be prepared in the currency of the contract of insurance (see chapter 6). The general principles to follow in translating currency amounts to sterling are set out in paragraphs 4 and 5 of Appendix 9.1. Assets and liabilities are required to be expressed in sterling as if conversion had taken place at the closing middle rate on the last day for which the appropriate rate is available in the financial year. For items of income and expenditure, such bases of conversion as are in accordance with generally accepted accounting practice are to be used. The basis of conversion adopted for income and expenditure is required to be stated by way of supplementary note to Form 16 (code 1601) or to Form 40 (code 4005) if there is no Form 16.

4.11. Completion to the nearer £000 is prescribed for all Forms within Appendices 9.1, 9.2 and 9.3 except for valuation unit prices which are to be shown to the accuracy used in the valuation. Use of the nearer £000 is optional for Appendix 9.5 and the rule 9.29 and 9.32A statement, but is required for the 9.25, 9.26 and 9.27 statements by rule 9.28(4)(c). £500 is to be rounded up and £499 rounded down. In the case of information shown in original currency on Forms 26 to 29, 31, 32 and 34, monetary units of 1,000,000 rather than 1,000 are to be used if the exchange rate of the currency in question to sterling at the end of the financial year exceeds 1,000 (Appendix 9.2 paragraph 4). Rounding can lead to small apparent differences within a Form since the rounded total of a series of unrounded figures may not be the same as the total of the rounded figures. There is no requirement to adjust figures to eliminate this, indeed the opposite is the case as totals are required to be rounded independently, and the validation checks applied to the return make allowance for rounding differences. There should

31 Applying this principle to non-monetary items (including unearned premiums and deferred acquisition costs) is anomalous, since GAAP requires these to be reported at the rate ruling at the date of the transaction, and not retranslated. Neither do the revenue Forms accommodate the exchange difference that the prescribed treatment inevitably creates; insurers typically deal with this problem in the way that appears most sensible to them.
never be rounding differences between two figures which are expected to agree directly with each other (e.g. Form 16 line 11 and Form 20 line 59).

4.12. In many cases the Accounts and Statements Rules require supplementary notes to be shown in relation to particular Forms. Paragraph 1(2) of Appendix 9.1 requires any such note to be presented as a separate statement, identifying the Form to which it relates, and not included on the face of the Form. Paragraph 4.6(1) of the repealed Guidance Note 9.1 indicated that it would be helpful if the supplementary notes could be grouped together, towards the end of the return (but before the directors' certificate), rather than being interleaved with the Forms to which they relate and for each supplementary note relating to Appendix 9.1, 9.2 or 9.3 to be given a title which identifies the Form or Forms to which it relates by inclusion of a prescribed four character reference code unique to that supplementary note. The first two characters of the code represent the Form number and the final two characters the particular note out of the range of notes that may be required for that Form. Thus the three prescribed supplementary notes to Form 21 (for example) are coded as 2101, 2102 and 2103. When Guidance Note 9.1 was repealed, the prescribed code numbers were moved into the rules, the Appendices and the Instructions to the Forms. If an insurer wished to include an additional note to Form 21 then this would be coded as 2104 even if the prescribed notes did not need to be present. If the Accounts and Statements Rules require a Form to be submitted but all entries (including comparatives) would be blank - for example Form 17 for an insurer that has no involvement whatsoever with derivatives - the Form may be omitted provided that a note coded FF00 (where FF is the Form number - in the example it would be 1700) is included stating that this is why the Form has been omitted. Furthermore, where a Form is omitted because of the operation of a de minimis limit, a note coded FF00 must also be included. A complete reference list of the prescribed reference codes has been included in appendix B; in addition, each reference in the text to a supplementary note cites the prescribed code.

4.13. Forms 1 to 3, 10 to 20, 40 to 46, 50, 58 and 60 all contain comparative figures. These are normally expected to repeat the current year figures that were reported in the previous return (after any corrections that the insurer is required to make as a result of rule 9.6(5) - see paragraph 5.8 below). Paragraph 7 of Appendix 9.1 indicates that "firms should not normally restate comparatives unless restatement is necessary in order to allow the appropriate comparison to be made", which leaves some uncertainty as to when restatement is required; the general GAAP presumption of GENPRU 1.3.4R would otherwise tend to suggest restatement for any change in accounting policy. There are prescribed supplementary notes (0111, 0211, 0311, 0411, 0511, 0611, 0711, 0811, 1011, 1111, 1211, 1311, 1411, 1511, 1611, 1711, 1811 and 1911, 2011, 4011, 4111, 4211, 4311, 4411, 4511, 4611, 5011, 5811 and 6011) to explain the restatement of comparatives.

5. Submission to the PRA

5.1. The deadlines for submitting the return to the PRA are set out in rule 9.6(1). The lodgement periods are 3 months in the case of returns deposited electronically (electronic submission is considered in paragraph 5.5 below) and 2 months and 15 days otherwise. Rule 9.6(1A) provides that where a due date is not a business day, the submission must be received by the PRA no later than the first business day after the due date. It is possible for an insurer to apply for a waiver, to extend the lodgement period (but the likelihood of such a waiver being granted is not high).

5.2. The deadlines need to be taken seriously, particularly as failure to meet these can lead to financial penalties being imposed upon a firm. The PRA has not 'inherited' the sections of the FSA Handbook dealing with penalties for late or incomplete submission of returns, but the...
FSA historically attached considerable importance to the timely submission by firms of reports as the information contained was essential to the FSA's understanding of whether the firm was complying with the requirements and standards of the regulatory system and to the FSA's understanding of that firm's business. There is no reason to believe that the PRA would view the matter differently. Firms should be aware that the FSA historically indicated that a report that was materially incomplete or inaccurate might be treated by the FSA as not received until it had been submitted in a form which was materially complete and accurate. In addition, in appropriate cases, the PRA could bring disciplinary action against the approved person or persons within the firm's management who have been apportioned responsibility for ensuring that the return is completed and submitted.

5.3. Historically, rule 9.6(3) required every document in the return other than the auditor’s report to be signed by prescribed signatories, though in practice insurers provided instead a cover sheet to Form 1 or 2 and (if the return was multi-volume) a cover sheet for each subsequent volume. The changes made by Legal Instrument 2013/28 have however deleted this requirement as from 31 December 2013. Accordingly, only the certificate prepared under Part I of Appendix 9.6 now needs to be signed. The signatories, as prescribed by rule 9.33, vary according to whether a global return or a UK/EEA branch return is being prepared.

(a) In the case of a global return there will normally be three signatures:

► two directors (or, if there is only one director, that director)
► the chief executive, if any, or if there is no chief executive, the secretary, if any.

Where the chief executive (or if there is no chief executive, the secretary) is on the board two fellow directors should sign as directors. If there are only two directors, one of whom is also the chief executive, then the chief executive should sign as a director, with the third signatory being the secretary. The term “chief executive” means the person who, either alone or jointly with one or more others, is responsible under the immediate authority of the directors for the conduct of the whole of the business.

(b) In the case of a UK branch return only two signatories are required:

► The authorised United Kingdom representative who is a person resident in the United Kingdom appointed by a non-UK insurer who is authorised to act generally and to accept service of any document on behalf of the insurer.

► The person (commonly referred to as the principal United Kingdom executive) appointed under rule 8.3 (or fulfilling an equivalent role for a Swiss general insurer) to be responsible (alone or jointly with one or more others) for the conduct of its business through an establishment in the United Kingdom.

5.4. The names of those signing should be stated (since signatures may not always be legible) together with the capacity in which a person signs (director, secretary, etc.) and the date of signature.

5.5. Most insurers present the return in an approved electronic format. This removes the need for rekeying of information provided in printed form, and enables validation procedures to be applied before submission, thus reducing the volume of errors and omissions in the return. Returns will be sent by e-mail to InsuranceData@bankofengland.co.uk (rule 9.6(2)). The return must be presented both in a form that is capable of being readily used or translated by the PRA and in pdf format (generated, not scanned from a hard copy). In addition, rule 9.6(3) and (4) require, respectively, the original signed certificate by Directors and auditor’s report to

35 The position is referred to in Article 3(1)(a) of the Financial Services and Markets Act (Variation of Threshold Conditions) Order 2001 (2001 No. 2507).
be scanned and included as separate pdf attachments. The title of the e-mail is also prescribed: <firm name> PRA returns <dd/mm/yyyy>. With effect from the 2013 year end, a printed copy is no longer required in addition to the electronic copies.

5.6. Where, pursuant to rule 9.6(6), an insurer is required to lodge with the PRA copies of reports to shareholders or policyholders, and does so in electronic form, these are not to be included as attachments to the submission of the return, but must be sent as separate e-mails to the same address but with different titles: <firm name> report and statements <dd/mm/yyyy> or <firm name> statements to with-profits policyholders <dd/mm/yyyy>.

5.7. If an insurer does not opt for electronic submission, the lodgement deadline is earlier. Only one copy is now required (historically, the FSA required five). The return must not be sent to the firm’s PRA supervisor; rather, rule 9.6(2) specifies the postal address to which the printed copy must be sent. This is:

- Regulatory Data Group
- Statistics and Regulatory Division (HO5 A - B)
- Bank of England
- Threadneedle Street
- London EC2R 8AH

5.8. After receipt of the return, the PRA will review the information contained therein. While the main thrust of the review is to identify regulatory concerns about the business and financial position of the insurer, the technical accuracy of the completion of the return will also be considered. Arising out of the review there may be requests for resubmission of certain parts of the return if particular documents appear to be inaccurate or incomplete. Rule 9.6(5) allows matters to be raised by the PRA within 24 months of the date of deposit, and gives insurers one month to respond. An insurer may be able to provide an explanation as to why there is not in fact any inaccuracy or incompleteness; if, however, it does have to resubmit, the relevant documents should be headed with the words “Amending document furnished pursuant to rule 9.6(5) of the Accounts and Statements Rules” so that its status is unambiguous. An auditor’s report on the amending documents is likely to be requested; the considerations that arise here are considered in chapter 9. In view of the high proportion of insurers with a 31 December year end, most of the returns will be submitted to the PRA at the same time and there may consequently be a significant delay before an insurer receives any response. It has not historically been any Regulator’s practice to issue a formal clearance of a return.

5.9. The return represents a public record document. Rule 9.7 requires an insurer to supply to any person, within 30 days of a request, a copy of the PRA return, any resubmitted Forms and any report submitted under rule 9.6(6). This requirement also extends to the returns for the two previous financial years. Either a printed or (if the return is submitted electronically to the PRA) electronic copy can be requested, but a charge for reasonable costs, including printing and postage, can be made by the insurer for a printed copy. In practice, a number of insurers make the return available on their websites. PRA return data products are also commercially available from Standard & Poor’s (SynThesys) and A M Best (Insight).
This chapter of the booklet concentrates on the capital resources that an insurer is required to maintain, section 1 discussing the concept of capital adequacy, and section 2 showing how an insurer’s capital resources are displayed on Form 3. Section 3 then describes the determination of capital requirement applicable to general insurance (including the Enhanced Capital Requirement) and section 4 that applicable to long-term insurance.

1. The concept of capital adequacy

1.1. A UK-incorporated insurer is, of course, subject to the normal requirements of the Companies Acts and will, in the case of a public company, require a minimum paid-up capital of £50,000 or the prescribed Euro equivalent. However, in view of the inherently uncertain nature of insurance business, a significantly greater degree of safeguard for the policyholders has been considered necessary in the case of an insurer. Three methods of achieving this have historically been applied:

(a) minimum paid-up share capital;

(b) deposits; and

(c) minimum capital requirements (margins of solvency).

1.2. There is no separate minimum requirement for the paid-up share capital of an insurer in the UK. Such a requirement is not sensitive to the amount of business that the capital is needed to support, and the likelihood of adverse development. Nonetheless, paid-up capital is still important since it represents the normal means of achieving the initial margin of solvency required of a newly incorporated insurer and of improving the margin where a deficiency has arisen. In addition, ratings agencies will tend to look for a substantial capitalisation in an insurer before they regard it as offering acceptable security, and this consideration may in some cases (e.g. general business reinsurers) necessitate an insurer having a higher capital than would be necessary to satisfy the PRA’s solvency requirements. This is even more the case when an insurer seeks one of the higher ratings.

1.3. At various times, insurers operating in the UK have been required to make deposits as a precondition of carrying on business. The only current requirement, which stems from European Directives, is that of INSPRU 1.5.54R for an external direct insurer to make and maintain a deposit with a BCD credit institution of at least one-quarter of the base capital resources requirement (see paragraph 1.13 below). As with the minimum paid-up share capital, this type of requirement can be regarded as insensitive to circumstances. The deposit is determined purely by the classes of business for which an insurer has permission under FSMA and is thus the same for an insurer with liabilities of £1,000 as for an insurer with liabilities of £10,000,000; in the majority of cases it will be the sterling equivalent at the rate prescribed for regulatory purposes of €925,000.

1.4. A “margin of solvency” is the term used by the current Directives to represent the amount by which the value of an insurer’s assets exceeds the amount of its liabilities. The Handbook now adopts a different terminology, but the underlying concept is similar. Essentially, a margin of solvency test applies a formula to some base figure (e.g. premiums, claims or mathematical reserves) to compute the required margin of solvency, and compares that to the surplus of assets over liabilities, both arrived at in accordance with valuation rules, to see whether the actual margin exceeds the required margin. Where an insurer fails to maintain the required minimum margin, remedial action is needed, which normally involves the

36 Since 1 March 2012, a firm has been required to advise the Regulator before it or another undertaking in its group issues any capital instrument which it wished to include as regulatory capital, other than most ordinary shares and capital instruments similar to those previously issued.

37 Historically, this deposit was made with the Accountant General of the Supreme Court, but this is now no longer the case; nothing in the relevant rules in INSPRU indicates that pre-N2 deposits with the Accountant General still count towards this requirement.
introduction of further paid-up share capital or other financing. Appendix 2 to the Supervision Manual requires an insurer failing to maintain its required margin to submit a plan to the PRA within 28 days of becoming aware of the breach for the restoration of a sound financial position, to propose modifications to the plan if the PRA considers it to be inadequate and to give effect to any plan accepted by the PRA as adequate. Matters are regarded as more serious and necessitating the submission of a short-term financial scheme if the actual margin falls below a figure defined by Appendix 2 as the higher of the guarantee fund – one-third of the general or long-term insurance capital requirement – and the base capital resources requirement, an absolute number of Euros based on the classes of business for which an insurer holds Part 4A permission.

1.5. Provided that the formulae are established on an appropriate basis, a margin of solvency requirement of this nature will vary according to the level of business carried on, and thus avoids the main objection to both minimum paid-up capital and deposits. Trading losses can erode an insurer’s actual margin, but this is equally true of the actual capital, and while a deposit is by definition “frozen”, the fact that part of an insurer’s assets is untouchable may accelerate the inability of the insurer to be able to discharge liabilities as they arise. Even though they are directly monitored in the return only once a year (or four times a year in the case of an insurer upon which a quarterly return requirement has been imposed), solvency margins are a day-by-day requirement. For a general insurer the required minimum solvency margin remains fixed for the whole of a financial year (unless there has been a significant change in the business portfolio), but for a life insurer the required margin itself varies from day to day.

1.6. By the mid-1990s, the requirements set out in the European Directives were becoming widely regarded as unsatisfactory, and following extensive study and discussion, a two-stage process was adopted by the European authorities, with a view to further harmonising solvency requirements and making them more effective. The first stage (“Solvency I”) resulted in two Directives adopted in 2002, intended to clarify, simplify, improve and update the existing rules and reflected in the UK’s current requirements; the second (“Solvency II”) represents a more fundamental review of the overall financial position of an insurance undertaking, recognising that the solvency margin is only one of a number of important factors, and addresses both financial factors such as the adequacy of technical provisions, asset and investment risk, asset and liability management, reinsurance arrangements and the accounting and actuarial methodologies, and non-financial issues such as the application of “fit and proper” criteria for management and the ability to make on-site inspections or supervise the operation of the insurance undertakings. The Solvency II Directive was adopted in 2009, and the detailed implementation measures are expected to be finalised in 2014, for implementation on 1 January 2016. As this is not directly relevant to the current year returns, Solvency II is not covered further in the body of this booklet, although appendix H has been included to summarise the key features.

1.7. It remains a key disadvantage of the margin of solvency requirements described above that any standard formula is arbitrary, and does not necessarily define an appropriate buffer fund for a particular insurer. This disadvantage was compounded by the fact that, at least for general insurance, the minimum Directive requirements were also widely considered to be set at a level that was too low, when coupled with “middle of the road” technical provisions. In the past, this had led in the UK to an expectation by the Regulator that insurers would cover the EU minimum twice (or a higher multiple for certain lines of business), while in certain other EU States insurers were expected to make more cautious provisions for claims.

1.8. As a consequence, the FSA developed and implemented an approach that was intended to overcome these disadvantages, and which the PRA now administers. In effect, two distinct initiatives were involved:

1. (1) A strengthening of the prescriptive requirements over and above those required by European Directives. This gave rise to an enhanced capital requirement (“ECR”). The ECR has a completely different character for general and life: for general it represents a more sophisticated formula which differentiates between lines of business and takes into account the levels of technical provisions and the spread of...
assets, whereas for life business it is based on any additional requirement necessary as a result of treating with-profits business on a realistic basis.

(2) A requirement for a firm to carry out an individual capital assessment (“ICA”) - a self assessment of its capital needs which is then reviewed by the Regulator. The Regulator takes this into account together with its own views as to the amount of capital that would be adequate to achieve its statutory objectives, and issues individual capital guidance (“ICG”) to firms.

1.9. These approaches are sometimes referred to as “pillar one” and “pillar two”, where pillar one represents formulaic minima, and pillar two regulatory review.38 Both are featured in GENPRU, although the status of the ECR for a general insurer is quite different from that which was originally envisaged, remaining as an informal requirement, outside the scope of the PRA return and subject to a separate reporting requirement (see paragraph 3.17ff below, and section 3 of chapter 11).

1.10. The key pillar one rule in GENPRU is 2.1.13R(1) which states that “An insurer must maintain at all times capital resources equal to or in excess of its capital resources requirement (CRR)”.39 This is very similar in concept to the Directive requirement to maintain a margin of solvency, but represents changes in terminology compared to the Directives, and some differences of substance. The differences of substance are:

(a) The implications of deriving capital resources starting from the shareholders’ funds side of the balance sheet instead of working from assets less liabilities, which can cause differences as a result, for example, of the limits on the credit that can be taken for particular types of capital;

(b) The inclusion for a regulatory basis life insurer40 of a resilience capital requirement as part of the overall capital resources requirement (previously resilience had been addressed in computing mathematical reserves); and

(c) The inclusion for a realistic basis life insurer of a with-profits insurance capital component (“WPICC”) as part of the overall capital resources requirement where surplus assets are less on a realistic basis than on a regulatory basis.

1.11. Some of these differences represent a change, compared with the equivalent treatment in Directives, between what is dealt with as a deduction from capital and what is dealt with as a capital requirement. Although the absolute answer may be the same, this can make a difference if a ratio is being calculated. Another example of this nature arises in respect of the regulatory capital requirements of regulated related undertakings, which are dealt with as a deduction from resources unless the insurer has to perform an adjusted solo calculation (see section 2 of chapter 10) in which case they are included in the group capital resources requirement. It is also worth noting that insurers continue to take a hit on their capital resources where assets are held in excess of market and counterparty limits, rather than this being treated as a capital charge. This means that analysts need to apply a degree of discrimination in drawing conclusions based on ratios derived from the returns.

1.12. Key items of terminology in the PRA’s approach to capital adequacy requirements are:

► The base capital resources requirement, which is an absolute number of Euros and corresponds to the minimum guarantee fund referred to in the Directives.

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38 This terminology was suggested by the Basel Committee formulation for banks, whereby the supervisory approach was composed of three pillars (the third being market disclosure discipline). In Solvency II, the boundaries between the pillars have shifted, and pillar two is considered to relate more to supervisory assessment of governance and risk control, with pillar one being seen as a more bespoke and individually approved basis for many insurers.

39 This is complemented by GENPRU 2.1.9R which requires an insurer to monitor at all times whether it is complying with GENPRU 2.1.13R and to be able to demonstrate that it knows at all times whether it is complying with that rule.

40 The concepts of and distinction between realistic and regulatory basis life insurers is discussed further in chapter 8, section 6.
The general insurance capital requirement ("GICR") and long-term insurance capital requirement ("LTICR") which correspond to the required margin of solvency referred to in the Directives. The specifics of the calculation of the GICR and LTICR are dealt with in INSPRU 1.1 and will be considered in sections 3 and 4 below.

The minimum capital requirement ("MCR") which represents for general insurance the higher of the GICR and the base capital resources requirement and for long-term insurance the higher of the sum of the LTICR and the resilience capital requirement, and the base capital resources requirement. It therefore corresponds, apart from the inclusion of the resilience capital requirement, to what was previously referred to as the required minimum margin.

The capital resources requirement ("CRR") which for general insurance is the same as the MCR, but for long-term insurance is the higher of the MCR and the ECR, with the ECR representing the sum of the LTICR, the resilience capital requirement and the WPICC (a long-term insurer will have either a resilience capital requirement or a WPICC, depending on whether it is a realistic basis life insurer or not, as defined in section 6.3 of chapter 8). It may seem slightly odd in the case of general insurance to have two different labels for the same yardstick figure, but this reflects the fact that the general insurance ECR does not represent a hard test (see paragraph 3.20 below).

1.13. The base capital resources requirement is dealt with by the table in GENPRU 2.1.30R which prescribes the following amounts for 31 December 2013.

<table>
<thead>
<tr>
<th>Category</th>
<th>Writing any of classes 10 to 15</th>
<th>Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>General insurer</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Directive mutual</td>
<td>€2.775 million</td>
<td>€1.875 million</td>
</tr>
<tr>
<td>Non-Directive insurer</td>
<td>€350,000</td>
<td>€26,000/€175,000</td>
</tr>
<tr>
<td>Mixed insurer</td>
<td>€3.7 million</td>
<td>€3.7 million</td>
</tr>
<tr>
<td>Other</td>
<td>€3.7 million</td>
<td>€2.5 million</td>
</tr>
<tr>
<td>Life insurer</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Directive mutual</td>
<td>€2.775 million</td>
<td></td>
</tr>
<tr>
<td>Non-Directive mutual</td>
<td>€700,000</td>
<td></td>
</tr>
<tr>
<td>Mixed insurer</td>
<td>€3.7 million</td>
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</tr>
<tr>
<td>Other</td>
<td>€3.7 million</td>
<td></td>
</tr>
<tr>
<td>Pure reinsurer</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Captive reinsurer</td>
<td>€1.2 million</td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td>€3.7 million</td>
<td></td>
</tr>
</tbody>
</table>

1.14. If a pure reinsurer is a composite, the base capital resources requirement will be split between Forms 1 and 2 for the purpose of regulatory reporting by applying the ratio of the GICR to the LTICR plus resilience capital requirement.

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41 The lower requirement applies if business is only carried on in classes 9 and 17.
42 A direct insurer with more than a prescribed (absolute and relative) de minimis amount of reinsurance business in addition to its direct business.
43 A pure reinsurer owned by a financial undertaking other than an insurance or reinsurance undertaking, or by a group of insurance undertakings or reinsurance undertakings to which the Insurance Groups Directive applies, or by a non-financial undertaking, the purpose of which is to provide reinsurance cover exclusively for the risks of the undertaking or undertakings to which it belongs, or of an undertaking or undertakings in its group.
1.15. For regulatory purposes, the sterling value of the Euro is prescribed for each period of 12 months beginning on 31 December by reference to the rate indicated in the EU Official Journal on the last day in the previous October for which the exchange rates for all member States were published. Under the Directives, the Euro amounts are subject to indexation by reference to the movement in European index of consumer prices. The PRA deals with such indexation by amending the relevant Handbook rules; no such changes were made in 2013.

1.16. The capital resources, with which the CRR is compared, are defined by the table in GENPRU 2 Annex 1R. This table is considered in the next section in the context of Form 3, as the Form is closely modelled on the table. The key point in the context of the pillar one/pillar two distinction is that the table is based on the application of the regulatory rules, and therefore reflects the impact of the Handbook requirements for the valuation of assets and the determination of liabilities.

1.17. The pillar two calculations including the ICA described in the following paragraph are, in contrast, based on realistic numbers. The key requirement appears in GENPRU 1.2.26R, which states that a firm must maintain overall financial resources, including capital resources and liquidity resources, which are adequate, both as to amount and quality, to ensure that there is no significant risk that its liabilities cannot be met as they fall due. This rule, and the related material in GENPRU 1.2, represents an amplification of Principle 4 of PRIN. A firm is required to carry out regular assessments of the adequacy of its financial resources using processes and systems which are commensurate to the nature, scale and complexity of its activities. The processes and systems must enable the firm to identify the major sources of risk to its ability to meet its liabilities as they fall due, including the major sources of credit risk, market risk, liquidity risk, operational risk and insurance risk and to carry out an assessment of how it intends to deal with each of the major sources of risk so identified.

1.18. A formal process must be performed under GENPRU 1.2.42R to carry out stress tests (shifting the value of individual parameters) and scenario analysis (varying a wider range of parameters at the same time) to identify an appropriate range of realistic adverse circumstances and events in which the risk identified crystallises, and estimate the financial resources which the firm would need in each of the circumstances and events considered in order to be able to meet its liabilities as they fall due. The results of the exercise need to be documented. The PRA corresponds with or visits insurers (depending on their perceived level of risk) to review their calculations and issue ICG. The PRA expects an insurer to be able to explain how its ICA has been assessed. An insurer is required for the purposes of this review to provide the PRA with 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 (INSPRU 7.1.42R). The Handbook guidance on the ICA has been complemented by guidance issued by the ABI.

1.19. Insurers are also subject to a reverse stress test requirement, whereby an insurer has to identify and assess the scenarios most likely to cause its current business plan to become unviable. The rules are contained in SYSC 20.

1.20. In its Approach document, the PRA indicated that it would also consider whether it was necessary to develop requirements for insurers to prepare recovery and resolution plans, such as are now required of banks. In the broader environment, those insurers designated by the Financial Stability Board as being globally systemically important (nine groups were so designated in 2013, with further reinsurance groups expected to be designated in 2014) are already required to prepare such plans. The European Commission has also consulted on the potential need for a resolution regime for non-banking financial institutions including...
insurance. There is clearly regulatory interest in requiring insurers to consider, plan and
document how they would recover from stressed positions or, if that is not possible, be
resolved without disruption to the financial system or cost to taxpayers. Although insurers
widely consider that such requirements would be excessive, at least for traditional insurance
business, the largest groups are already subject to them through the Financial Stability
Board designations and European and UK regulators may in time extend their application.
The Regulators already, where supervisory reasons exist, require an insurer to demonstrate
how a particular arrangement would be resolved in a stress scenario.

2. Summary of the solvency position (Forms 1, 2, 3 and 10)

2.1. The return commences with separate Forms 1 and 2 which provide a statement of solvency
for general insurance business and long-term insurance business respectively. The main
purpose of Forms 1 and 2 is to highlight the key comparison between capital resources and
the CRR, although some additional tests are monitored. The GICR and LTICR which feed
into the CRR are derived from Forms 12 and 60 respectively, while in the case of a global
return the capital resources are derived from Form 3. However, Form 10, rather than Form 3,
is used in the case of a UK or EEA branch return, as the FSA concluded when developing its
approach that the tiers of capital analysed on Form 3 are irrelevant to a branch as this is not
a separate legal entity. Form 3 will be considered first. This chapter will deal with the
completion of these Forms on a solo basis: the different considerations arising when an
adjusted solo calculation is performed by a participating insurance undertaking will be
addressed in section 2 of chapter 10. The Forms are accompanied by a large number of
instructions in order to cover the two possible bases of completion, particularly Form 3 which
is accompanied by no fewer than 68 Instructions. When Form 3 is completed on a solo basis,
lines 16, 23, 26, 28, 36, 47, 53 and 77 will not contain figures.

2.2. Form 3 shows the derivation, over three pages, of capital resources from the shareholders’
funds side of the balance sheet, and is not directly linked to Forms 13, 14 and 15. However,
the reconciliation of net admissible assets to capital resources after deductions required in
supplementary note 0301 (considered in paragraph 2.21 below) demonstrates that the two
sides of the regulatory balance sheet are consistent with each other. The construction of the
Form is largely designed to mirror the GENPRU 2 Annex 1R table of capital resources (lines
11 to 79). It then identifies available capital resources for what will be referred to as the “EU
Directive tests” (lines 81 to 83) and concludes with an analysis of financial engineering
adjustments (lines 91 to 96) which are relevant only to an insurer carrying on long-term
insurance business. The Form has separate columns for general insurance business (1) and
long-term insurance business (2) which are totalled in column 3. An insurer only carrying on
general insurance business will have no entries in column 2 and an insurer only carrying on
long-term insurance business will have no entries in column 1. A composite will have entries
in both columns, but in populating these columns it will allocate capital arising outside the
long-term insurance fund between general insurance business and long-term insurance
business in a manner consistent with the firm’s view of what business that capital supports.
Any material change from one year to the next in the way capital items are allocated must be
explained in a supplementary note (code 0303). Any capital instruments issued by the long-
term insurance fund must also be analysed in a supplementary note (0302).

2.3. The table in GENPRU 2 Annex 1R is key, as this defines the items which qualify as capital
resources for the purpose of GENPRU 2.1.13R. The sections of the table, and the
 corresponding line references on Form 3, are as follows: each section, together with the
implications for the completion of Form 3, is covered in detail in the ensuing paragraphs.
There are some slight misfits in the linkages, which will be explained in the ensuing
paragraphs, because the other capital resources in section N of the table are incorporated
within tier one or tier two on Form 3. Many insurers will not have any non-core tier one or tier
two capital. Where this is the case, it will be relatively straightforward to complete Form 3,
and sheet two will be blank.

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46 Save for a Swiss general insurer or EEA-deposit insurer which is not subject to solvency requirements in the UK
for which Form 10 will be the first Form.
47 Form 10 was used for all insurers prior to the introduction of Form 3; at that time the return began, rather
illogically, with the now obsolete Form 9 which fulfilled the function now carried out by Forms 1 and 2.
A  Core tier one capital (line 19)
   Permanent share capital (line 11)
   Profit and loss account and other reserves (line 12)
   Share premium account (line 13)
   Externally verified interim net profits (not relevant for an annual return)
   Positive valuation differences (line 14)
   Fund for future appropriations (line 15)
B  Perpetual non-cumulative preference shares (line 25)
C  Innovative tier one capital (line 27)
D  Total tier one capital before deductions = A + B + C (line 31)
E  Deductions from tier one capital (line 37)
   Investments in own shares (line 32)
   Intangible assets (line 33)
   Amounts deducted from technical provisions for discounting and other negative valuation differences (lines 34 and 35)
F  Total tier one capital after deductions = D – E (line 39)
G  Upper tier two capital (line 49)
   Perpetual cumulative preference shares (line 45)
   Perpetual subordinated debt (line 46)
   Perpetual subordinated securities (line 46)
H  Lower tier two capital (line 59)
   Fixed term cumulative preference shares (line 55)
   Fixed term subordinated debt (line 56)
   Fixed term subordinated securities (line 56)
I  Total tier two capital = G + H (line 69)
J  Positive adjustments for related undertakings (line 71)
K  Total capital after positive adjustments for regulated related undertakings that are not insurance undertakings but before deductions = F + I + J (line 72)
L  Deductions from total capital (line 79)
   Inadmissible assets (line 73)
   Assets in excess of market risk and counterparty limits (line 74)
Related undertakings that are ancillary services undertakings (line 75)

Negative adjustments for related undertakings that are regulated related undertakings (other than insurance undertakings) (line 76)

M Total capital after deductions = K – L (no direct equivalent because of N)

N Other capital resources

Unpaid share capital or, in the case of a mutual, unpaid initial funds and calls for supplementary contributions (line 21)

Implicit items (line 22 or 41)

O Total capital resources after deductions = M + N (line 79)

2.4. Tier one capital has the following characteristics (GENPRU 2.2.9G):

(a) it is able to absorb losses;
(b) it is permanent;
(c) it ranks for repayment upon winding up after all other debts and liabilities; and
(d) it has no fixed costs, that is, there is no inescapable obligation to pay dividends and interest.

It is the PRA’s preference that firms hold capital with these characteristics, as this is of a higher quality, and for the items in A qualifying as core tier one capital, there are therefore no limits. The permanent share capital within core tier one can be an ordinary share, a members’ contribution or part of the initial fund of a mutual, and there must be no contractual obligation to pay dividends or repay the capital (GENPRU 2.2.83R). In completing Form 3, the figures at lines 11 to 13 and 15 come directly from the accounts.

2.5. A valuation difference arises where the regulatory value of an asset or liability differs from its accounts value, other than items that are dealt with specifically elsewhere in the GENPRU 2 Annex 1R table (e.g. because the asset is inadmissible or impacted by the market risk and counterparty exposure limits). The sum of the valuation differences will be reported either at line 14 if the net is positive or at line 34 if the net is negative (i.e. there is no apportionment of positive differences to line 14 and negative differences to line 34, and there should not be an entry at both lines).48

2.6. A positive difference might arise if the market value of an investment is higher than the amortised cost at which it is carried in the accounts, or if the full value of a pension fund deficit is not recognised for regulatory purposes. Conversely a negative valuation difference might arise when an investment is valued more prudently in the return than in the accounts, when the long term business provision is stated at less in the accounts than in the return (which commonly occurs due to the regulatory valuation rules for mathematical reserves), or where a pension fund asset is valued at nil for regulatory purposes.

2.7. Supplementary note 0310 provides an analysis of the net valuation differences, with in each case a brief explanation, indicating the nature of the assets or liabilities concerned, into:

(a) positive valuation differences for assets where the GENPRU value exceeds the accounts value;
(b) positive valuation differences for liabilities where the GENPRU value is lower than the accounts value;

48 See paragraph 2.2 of chapter 4.
negative valuation differences for assets where the GENPRU value is lower than the accounts value (other than inadmissible assets and assets in excess of market risk and counterparty limits); and

d) negative valuation differences for liabilities where the GENPRU value is higher than the accounts value (excluding amounts deducted from technical provisions for discounting).

2.8. In compiling supplementary note 0310, regard should be had to the requirements of GENPRU 1.3.34R to present a reconciliation where the insurer has adjusted the value according to GAAP\(^4\) by applying valuation adjustments or reserves in accordance with GENPRU 1.3.30R. Although Form 13 provides a summary reconciliation to accounts values, this supplementary note is where detail of the adjustments can be presented. In view of the PRA's stated focus on valuation uncertainty, it may be expected to examine the disclosures that firms make.

2.9. Perpetual non-cumulative preference shares are part of tier one, but they do not represent core tier one and are therefore subject to restriction. However, the restriction is relatively generous, because alongside the basic requirement of GENPRU 2.2.29R that at least 50% of total tier one capital resources after deductions (F) should be represented by core tier one capital, GENPRU 2.2.25R indicates that any capital item excluded from tier one capital resources because of the capital resources gearing rules may form part of its tier two capital resources. Since, as will be seen, total tier two capital resources of an amount equal to total tier one capital resources can be included, this means that there is in effect a multiplier in operation, and an additional £1 million of permanent share capital will enable an additional £3 million of perpetual non-cumulative preference shares to qualify as regulatory capital (£1 million within other tier one and £2 million within tier two). In completing Form 3, only the amount which is eligible under GENPRU 2.2.29R is included at line 25, an approach which is curiously inconsistent with the section of the Form relating to tier two capital, where the full amount of the capital is reported, with the ineligible portion being deducted at a later line.

2.10. Innovative tier one capital is encountered rarely in practice, although a substantial section of the rules (GENPRU 2.2.113R to 2.2.154G) is devoted to such instruments. A tier one instrument will be regarded as innovative, and therefore as falling under C rather than A or B of the table, if it is redeemable at the option of the firm other than solely in cash, or is redeemable and issued on terms such that a reasonable person would think that the firm is likely to redeem it or to have a substantial economic incentive to redeem it.\(^5\) Such characteristics make the capital less permanent, and a harsher limit is applied by GENPRU 2.2.30R to such capital: no more than 15% of tier one capital resources may be accounted for by innovative tier one capital. The multiplier effect referred to in the previous paragraph therefore operates in a less generous way. An additional £1 million of permanent share capital would support an additional £1,352,941 of innovative tier one (15/85th of the £1 million in tier one and 100/85th in tier two). Except in the case of a preference share, GENPRU 2.2.118R requires a firm to obtain an independent legal opinion from an appropriately qualified individual\(^6\) that the requirements of GENPRU 2.2.64R(6) and GENPRU 2.2.80R and 81R concerning the loss absorbency of an innovative tier one instrument have been satisfied.

2.11. Certain deductions are made at section E from tier one capital resources rather than from total capital resources. For an insurer that has only tier one capital, the distinction is academic, and it simply determines the particular line on Form 3 where the deduction is reflected. However, for an insurer with tier two capital, it would be advantageous for a deduction to be made from total capital resources, since it is the tier one capital after deductions that serves to define the maximum credit that can be taken for tier two capital.

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49 The rule refers to a reconciliation to ‘the fair value determined according to GENPRU 1.3.4R; as that rule would not necessarily result in fair value, it is assumed that the text of the rule is in error and that ‘value’ is meant.

50 A step-up, whereby the initial coupon rate would increase from a particular date if the instrument has not been redeemed would be such a condition.

51 GENPRU 2.2.119G states that the appropriately qualified individual may be an employee of the firm, subject to internal independence considerations spelt out in the guidance.
should be noted that both investments in own shares (which are very rare) and intangible assets would anyway represent inadmissible assets for a direct insurer as they do not appear in GENPRU 2 Annex 7R. However the table requires the insurer to deduct them from tier one capital resources rather than from total capital resources at line 73, which is the prescribed treatment for other inadmissible assets. (It follows too that a pure reinsurer must also deduct these items from tier one capital, notwithstanding that pure reinsurers are not subject to GENPRU 2 Annex 7R.) Amounts deducted from technical provisions for discounting are considered in section 4 of chapter 5: negative valuation differences are the counterpart of the positive valuation differences referred to in paragraph 2.6.

2.12. Tier two capital instruments are capital instruments, such as cumulative preference shares and subordinated debt, which combine the features of debt and equity in that they are structured like debt but exhibit some of the loss absorption and funding flexibility features of equity. The equity-like features must be sufficient to enable capital treatment to be allowed, but the debt elements mean that there are limits on the credit that can be taken which are stricter than the limits already discussed. There is extensive GENPRU text on the conditions for eligibility of tier two capital (including requirements for legal opinions as to compliance with those conditions) which it would be outside the scope of this publication to cover in detail. Tier two is split into upper and lower tiers, with upper tier two comprising perpetual instruments and lower tier two comprising dated instruments. Under GENPRU 2.2.37R, a firm must exclude from the calculation of its capital resources:

1. the amount by which tier two capital resources exceed tier one capital resources after deductions; and
2. the amount by which lower tier two capital resources exceed 50% of tier one capital resources after deductions.

In effect £1 million of tier one capital after deductions will support £1 million of tier two capital, but only £500,000 of this tier two capital can be lower tier two. The full amount of tier two capital instruments is reported on sheet 2 of Form 3 together with any elements of non-core tier one capital in excess of the tier one limits (which would need to be the subject of supplementary note 0304). Any restrictions because of the tier two limits are then dealt with at lines 62 and 63: line 62 relates to restriction (1) above and line 63 to restriction (2).

2.13. Positive adjustments for regulated related undertakings at line 71 arise only in respect of non-insurance undertakings: if the Form is prepared on a solo basis there are, by definition, no regulated related insurance undertakings. The basis of the valuation of related regulated undertakings is explained in paragraphs 2.13 to 2.17 of chapter 4, and in essence involves the calculation of a regulatory surplus value based on a comparison between the sum of the related undertaking’s own capital resources and its individual capital resources requirement (CRR). Line 71 will contain an entry for the difference between the regulatory surplus value and the book value of the investment where the regulatory surplus value is higher: if it is lower, an entry will be made at line 76. The other deductions from total capital resources relate to specific asset recognition and eligibility rules which are considered in chapter 4: inadmissible assets are covered in section 3 of that chapter, assets in excess of market risk and counterparty limits in section 4 of that chapter and ancillary services undertakings in paragraph 2.18 of that chapter.

2.14. The items included in section N of the table can only be taken credit for if a waiver has been obtained. Although section N is the final element of the table before total capital resources are determined, Form 3 classifies the various elements at particular lines within tier one capital and (in the case of implicit items) tier two capital. The relevant waivers will make the tier one or tier two status clear. Of the three elements of section N:

(1) Partly-paid shares are rare. Under the EU Insurance Directives, it is possible for credit to be taken for solvency purposes of 50% of the unpaid element of partly paid

52 References to “perpetual” in GENPRU do not mean that an instrument cannot be redeemed, but that there is no date by when it is required to be redeemed.
Chapter 3 – Capital resources

shares provided that at least 25% of the nominal value and any share premium are paid up. In addition, it is a pre-condition that an application, with supporting information, is made by the undertaking to the competent authority of its home member State and that the authority agrees, hence the waiver requirement. The Regulators have historically been very reluctant to grant such waivers.

(2) Supplementary calls may be recognised by a mutual with variable contributions, up to one half of the difference between the maximum contributions and the amount actually called in for the financial year, and subject to a limit of 50% of the lesser of the available solvency margin and the required solvency margin. Supplementary calls have been used in the past by a number of P&I clubs to cover part of their solvency requirements, and a waiver is much more likely to be obtained here rather than under (1) above.

(3) Implicit items are the items referred to in Article 27 of the Consolidated Life Insurance Directive which, although not admissible assets in their own right, may be counted towards solvency requirements “upon application, with supporting evidence by the undertaking to the supervisory authority of the Member State in the territory of which its head office is situated and with the agreement of that authority”. There were three types of implicit item, of which only two remain available (the third being future profits in respect of life business, which the Directives no longer allow). The remaining two are:

(i). zillmerising where it is not practised in the actuarial valuation or is at a rate less than the loading for acquisition costs included in the premium

(ii). hidden reserves resulting from the underestimation of assets and overestimation of non-actuarial liabilities.

2.15. Neither of these is regularly encountered in practice, though the future profits item was, when permitted, more frequently used. Where an implicit item waiver has been issued, an explanation needs to be provided in supplementary note 0312. Annex 8G to GENPRU 2 provides guidance on applications for waivers relating to implicit items. This Annex includes the guidance that implicit items may form part of tier one capital or tier two capital, but cannot form part of core tier one capital, neither may they cover the guarantee fund. As indicated above, any waiver granted will indicate where in the capital resources table the item may be included, and will if necessary modify other rules to ensure that these two limitations are achieved.

2.16. Lines 81 to 83 identify the capital resources which are eligible for the purpose of three supplementary tests prescribed by GENPRU. The purpose of these tests is to ensure that in areas where the GENPRU rules may be relatively generous in terms of the admissibility of certain types of capital, the minimum requirements of the EU Directives are nonetheless satisfied. For insurers with no tier two capital, these tests are academic, and the entry at each of these lines will normally be the same as total capital resources at line 79. The three tests are as follows.

(1) GENPRU 2.2.32R. At least 50% of the MCR must be represented by items A and B from the table in GENPRU 2 Annex 1R. The qualifying capital resources are reported at line 82 of Form 3, which will report the sum of lines 19, 24, 25 and 42 less line 37, where this is less than line 79 (Instruction 31).

(2) GENPRU 2.2.33R and 2.2.34R. The higher of one-third of the LTICR or GICR as appropriate and the base capital resources requirement must be covered with the sum of the items listed at stages A, B, G and H less the items listed in stage E of the table of GENPRU 2 Annex 1R. The qualifying capital resources are reported at line

53 A technique devised by a German actuary named August Zillmer for modifying the net premium reserve method of valuing a long-term policy by increasing the part of the future premiums for which credit is taken so as to allow for initial expenses.
81 of Form 3, with instruction 30 defining a very precise but potentially confusing formula for deriving the figure.

(3) GENPRU 2.2.38R. At least 75% of the MCR must be accounted for by the sum of the amount calculated at stage A plus stage B minus stage E plus stage G in the table in GENPRU 2 Annex 1R. The qualifying capital resources are reported at line 83 with Instruction 32 specifying a further challenging formula for deriving the figure.

2.17. Tests (1) and (3) in the foregoing paragraph relate to the differences in the treatment of cumulative preference shares and subordinated debt between the Directives and GENPRU. Under the EU Directives no more than 50% of the required margin of solvency may be represented by such instruments and no more than 25% by such instruments that are redeemable. The GENPRU rules allow a greater value to be applied to such instruments as the tier two restrictions are expressed in terms of tier one capital after deductions rather than the required margin, while the lower tier two requirements effectively amount to one-third rather than 25% of total capital resources. The supplementary tests enforce the Directive requirements indirectly by ensuring that 50% or 75% of the requirements are covered by higher quality items. Test (2) relates to the guarantee fund requirement.54

2.18. Lines 91 to 96, which are only relevant to long-term insurance business, relate to financial engineering adjustments. “Financial engineering” is an umbrella term for certain types of arrangement (such as financial reinsurance, implicit items and contingent loans) used by insurers for financing or regulatory reporting purposes or both, which are used to improve, or sometimes to smooth, reported profits, or to improve the reported balance sheet position. The PRA recognises that financial engineering can be a valid method of strengthening a firm’s solvency position where there is a genuine and material transfer of risk or of accessing overly prudent economic reserves within the technical provisions of life insurers. However, concerns arise where its use obscures the underlying financial condition of a firm or is designed to mislead consumers or regulators, so transparency is also an issue. The PRA therefore emphasises the importance of management satisfying itself about the purpose and effect of any financial engineering and the credit taken for regulatory solvency purposes, and requires clear presentation in the regulatory returns of insurers carrying on long-term insurance business of the effect of financial engineering on the financial condition both of the firm as a whole and of individual with profits funds and, for non-life business, additional regulatory reporting of reinsurance arrangements.55

2.19. Financial engineering adjustments for long-term insurance business56 are analysed under five headings and totalled at line 96 of Form 3. Any arrangement relating to long-term insurance business which is not entered at lines 91 to 95 but which falls within the definition of financing arrangement in paragraph 9(3) of Appendix 9.4 must be disclosed in a supplementary note (code 0305). The five headings are as follows.

(a) Value of implicit items (line 91). This will equal the sum of the entries at lines 22 and 41.

(b) Financial reinsurance – ceded (line 92). This will represent any contingent liability to repay a debt or recapture a liability from a reinsurer not already recognised in the balance sheet. A supplementary note (code 0306) is required to provide the following information on each material reinsurance arrangement:

(i) the amount of any reinsurance offset (i.e. the amount of the difference between the mathematical reserves at the end of the financial year were that

54 The guarantee fund requirement seems a little strange as unless a firm’s base capital resources requirement is high in relation to its LTICR or GICR, this allows a wider range of capital resources to be used to cover one-third of the LTICR or GICR under test (1). It is true that the capital item at stage E needs to be deducted in test (2), but a little hard to understand why it needs to be deducted in (3) but not (1).

55 The additional regulatory reporting for non-life business takes the form of the rule 9.32A statement – see chapter 7.

56 The Form design allows for the possibility of an implicit item in respect of general insurance business, but that seems very unlikely to arise in practice.
reinsurance to be ignored and the amount of mathematical reserves after deducting the mathematical reserves reinsured;

(ii). the amount of the contingent liability for payment to the reinsurer; and

(iii). the commutation value at the end of the financial year of the reinsurance arrangement.

(c) Financial reinsurance – accepted (line 93). This is a mirror line, in relation to inwards reinsurance, to line 15; any arrangement will be described in supplementary note 0307. A figure reported at this line will need to be deducted in arriving at the line 96 total.

(d) Outstanding contingent loans (line 94). The figure is the amount, including any interest accrued, still to be repaid from future profits under the arrangements at the end of the financial year, not already recognised in the balance sheet. An explanation of the adjustments must be provided in supplementary note 0308, together with the amount of the adjustment for each major arrangement. As part of this supplementary note, the commutation value of each of the items included, to the extent that this value is not already a component of line 79, must be disclosed.

(e) Other charges on future profits (line 95). This is the sweep up line for disclosure of the gross contingent liability not already recognised in the balance sheet for potential charges against future profits in respect of other types of financial engineering. Supplementary note 0308 requirements are as for line 17.

2.20. Details of any promises to long-term insurance business policyholders conditional on future profits (other than bonuses not yet declared), or other charges to future profits not already disclosed must be provided in supplementary note 0309.

2.21. Instruction 66 to Form 3 requires the preparation of supplementary note 0301 to provide a reconciliation between net admissible assets and capital resources after deductions. This note has the following prescribed elements:

(i). Net admissible assets - Form 13 line 89 (category 1 and 10) less Form 14 lines 11, 12 and 49 and Form 15 line 69.

(ii). Any components of capital resources that are treated as a liability in Form 14 or 15 (e.g. cumulative preference shares and subordinated loan capital).

(iii). Any components of capital resources that arise under a waiver and are not represented by admissible assets on Form 13 (e.g. implicit items and supplementary calls).

(iv). Any other reconciling items, each such item to be separately identified.

2.22. (i) plus (ii) plus (iii) plus or minus (iv) will equal capital resources after deductions at Form 3 line 79. For the majority of insurers there will no items to report under (ii), (iii) or (iv):\(^{57}\) if there are items these will need to be specified and linked to Form disclosures.

2.23. Instruction 68 to Form 3 requires the inclusion of a supplementary note (code 0313) providing a reconciliation of profit and loss account and other reserves (Form 3 line 12) as at the end of the financial year and the end of the previous financial year (columns 3 and 4) to the profit and loss retained per Form 16 line 59. This reconciliation, which should be provided even if there are no reconciling items, avoids the loose end in the return that would otherwise arise from the bottom line of Form 16 not going anywhere.

\(^{57}\) Although as explained in chapter 10, there will invariably be a reconciling item when Form 3 is prepared on an adjusted solo basis.
2.24. Form 10 is completed instead of Form 3 in a branch return. This is a simpler Form to understand, as figures are derived directly from Forms 13, 14 and 15. The Form incorporates a useful reconciliation of the movement of net admissible assets at line 23, which as explained in the previous paragraph has an equivalent in relation to Form 3 in supplementary note 0313. Apart from the profit (line 62) derived from 16.59.1, the movement in asset valuation differences (line 63) and the movement in the provision for reasonably foreseeable adverse variations (line 64) derived from 15.61.2 less 15.61.1 (see chapter 4 section 5), there is an “other” movements line (65). Particulars of any entry at this line are required to be specified in a supplementary note (code 1002); this seems most likely to relate to the effect of exchange rate movements, or transfers of funds to or from head office.

2.25. The main purpose of Forms 1 and 2 is to monitor compliance with GENPRU 2.1.13R. The key lines are therefore 13, which states the capital resources available, 41 which states the CRR and 42 which states the excess or deficiency of the available capital resources compared with the CRR, but the following elements are also present on the Form:

(a) allocation of capital resources arising outside the long-term insurance fund;
(b) derivation of the CRR from the GICR and the LTICR;
(c) the supplementary GENPRU tests; and
(d) contingent liabilities.

2.26. There are three situations to distinguish in respect of the allocation of capital resources.

► For an insurer that only carries on general insurance business, Form 2 will not be completed and all capital resources will be allocated on Form 1 towards the general insurance business CRR. There will be no entry at Form 1 line 12, so lines 11 and 13 will be the same, and the entry at these lines will agree to Form 3 line 79 columns 1 and 3, or Form 10 line 23 in the case of a branch.

► For an insurer that only carries on long-term insurance business, Form 1 will not be completed and all capital resources will be allocated towards the long-term insurance business CRR. Form 2 line 13 will agree to Form 3 line 79 columns 2 and 3, but except for a mutual the line 13 capital resources are likely to arise partly within and partly outside the long-term insurance fund. The entries on Form 14 at lines 13 (surplus) and 51 (excess of the value of net admissible assets) represent capital resources arising within the long-term insurance fund, as do implicit items. For a branch, line 12 will be equal to Form 10 line 23, and line 11 will be equal to the sum of any implicit items plus Form 10 line 11, less the sum of Form 14 lines 11, 12 and 49. When there are implicit items in a branch a supplementary note (code 0202) is required to provide an analysis of line 11.

► A composite insurer is required to comply separately with the CRR for long-term insurance business and for general insurance business and therefore prepares both Form 1 and Form 2. As explained in paragraph 2.2 above, capital resources arising outside the long-term insurance fund will be allocated, in completing Form 3, between general insurance business and long-term insurance business in a manner consistent with the firm’s view of what business that capital supports. Any allocation of such capital resources towards long-term insurance business will be reflected by entries at line 12 of both Form 1 (where this is deducted in arriving at line 13) and Form 3 (where it is added). The line 13 entries on Forms 1 and 2 at line 13 will agree to Form 3 line 79 columns 1 and 2 respectively.

2.27. Forms 11 and 12 show the calculation of the GICR and Form 60 the calculation of the LTICR. The figures so calculated are taken to line 31 of Forms 1 and 2 respectively, and the Form then shows the other elements referred to in paragraph 1.12 above which have to be taken into account in arriving at the MCR and CRR. The resilience capital requirement, which is applicable to a non-realistic basis life insurer as discussed in paragraph 4.10 below, is
reported at line 32 of Form 2: line 33 of both Forms represents the base capital resources requirement determined in accordance with the GENPRU 2.1.30R table summarised in paragraph 1.13 above (or, in the case of a UK branch return, one half of the relevant figure in the table). The MCR at line 34 is the higher of line 31 (plus, in the case of Form 2, line 32) and line 33. For general insurance, the CRR at line 41 of Form 1 is the same as the MCR at line 34. For long-term insurance, a WPICC (see chapter 8) has to be calculated by a realistic basis life firm and reported at line 37, which will enable the ECR to be calculated at line 38 as the sum of lines 31, 32 and 37. The CRR at line 41 is then the greater of lines 34 and 38.\(^{59}\)

2.28. The three supplementary GENPRU tests referred to in paragraph 2.16 above are all monitored on the face of the Forms. The guarantee fund requirement, to which GENPRU 2.2.33R and 2.2.34R relate, is stated at line 21 and represents the higher of the base capital resources requirement at line 33 and one third of the MCR at line 34. This is then compared with the eligible assets computed at line 81 of Form 3 and the excess or deficiency is reported at line 22. For the other two tests, line 37 represents a comparison between the available capital resources to cover 50% of the MCR as computed at line 82 of Form 3 and 50% of the MCR at Form 1 or 2 line 34, while line 38 represents a comparison between the available capital resources to cover 75% of the MCR as computed at line 83 of Form 3 and 75% of the MCR at Form 1 or 2 line 34.

2.29. In the case of a UK or EEA branch return, the 50% and 75% tests do not apply and lines 37 and 38 are to be left blank. The guarantee fund test does apply, but a different source has to be used to complete line 22 as there is no Form 3 in a branch return. The line 22 entry will be based on line 13 minus line 21, but with an adjustment to exclude assets held outside the United Kingdom (alternative provisions apply to an EEA branch return – refer to appendix E) and implicit items. For a composite branch, Instruction 7 to Form 1 requires a supplementary note (code 0102) analysing how the adjustment has been split between general insurance business and long-term insurance business: for a life insurer, Instruction 6 to Form 2 indicates that supplementary note 0203 should be included to provide an analysis of how the line 22 entry has been arrived at.

2.30. The final line (51) of Forms 1 and 2 relates to quantifiable contingent liabilities shown in a supplementary note to Form 14 or 15 (i.e. not provided for on those Forms). Any provision for liability to tax on capital gains is excluded by the Instructions to the Forms, because the supplementary note in this specific case states the amount that has actually been provided. It should be noted that these lines are left hanging – there is no statement of excess (deficiency) after taking into account contingent liabilities, although this can be readily computed from the information given.

3. Computing the general insurance capital requirement (Forms 11 and 12)

3.1. Forms 11 and 12 compute the general insurance capital requirement by applying two formulae, based respectively on premiums for a financial year and average claims incurred over a longer reference period. The formulae may be summarised as follows in respect of financial years ending on or after 31 December 2013:

\[
\text{First method - } 16\% \text{ to } 18\% \text{ of } 2013 \text{ gross premiums written or (if higher) earned} \\
\times \frac{2011 \text{ to } 2013 \text{ net claims incurred}}{2011 \text{ to } 2013 \text{ gross claims incurred}} \text{ (or } 50\% \text{ if higher, or } 100\% \text{ if lower)}
\]

\(^{58}\) Instructions 9 to Form 1 and 17B to Form 2.

\(^{59}\) Although in practice, the MCR cannot be higher than the ECR as the WPICC cannot be negative.
(b) Second method - 23% to 26% x average annual gross claims incurred for 2011 to 2013

\[
\text{Second method} = \frac{2011 \text{ to } 2013 \text{ net claims incurred}}{2011 \text{ to } 2013 \text{ gross claims incurred}} \times (\text{or } 50\% \text{ if higher, or } 100\% \text{ if lower})
\]

3.2. The higher of the two results will normally represent the GICR. However, if their application would give rise to a lower GICR than the previous financial year, an additional brought forward method comes into play and limits the reduction that may be applied by reference to the proportionate fall in the provision for net outstanding claims during the year. The GICR with which Form 12 concludes (12.43.1) is taken to Form 1.

3.3. Forms 11 and 12 are not only relevant to general insurance business. The capital requirement for certain types of long-term insurance business (as explained in paragraph 4.1 below) also has to be calculated on this Form. There is a “General/long-term insurance business” option in the heading, and a composite insurer may need to complete two versions of these Forms. The figure at line 43 of a Form 12 prepared for long-term insurance business is taken to Form 60.

3.4. The figure to which the premiums basis calculation is applied on Form 11 is referred to as “gross adjusted premiums” by INSPRU. This is arrived at by taking as the starting point gross written premiums (11.11.1)\(^\text{60}\) and gross earned premiums (11.21.1), making a number of adjustments to each of these, and using the higher of the figures so obtained. The adjustments that have to be made are as follows:

(a) In arriving at the figures to include at lines 11 and 21, transfers of business need to be dealt with in accordance with INSPRU 1.1.66R. These provisions relate to transfers under Part 7 of FSMA or earlier UK legislation or overseas equivalents, or to novations. The figures must exclude any amount included in premiums to reflect the consideration for a transfer to or from the firm, exclude premiums which relate to contracts of insurance which have been transferred to another body and account for premiums on contracts transferred to the firm from another body from inception as if they were receivable by the firm. This rule is logical, as it relates the calculation to the policies to which the insurer is exposed at the end of the financial year.

(b) Instruction 10 to Forms 11 and 12 indicates that while normal accounting conventions will usually apply to the determination of premiums reported in the return by virtue of GENPRU 1.3.4R, the premiums for the calculation of the GICR are defined by reference to contracts of insurance which are themselves defined by the Regulated Activities Order. Consequently premiums will be included on Form 11 even for contracts that would not be accounted for as insurance under normal accounting conventions.

(c) Premium taxes and levies are deducted. These are reported at lines 12 and 22, and deducted to arrive at the sub-totals at lines 13 and 23. Insurance premium tax will not feature at these lines since under GAAP it will not have been included within premiums written/earned to begin with, and they are therefore likely to be used rarely in practice.\(^\text{61}\)

(d) Class enhancement, involving a 50% loading, has to be applied to liability business falling within the aviation (11), marine (12) and liability (13) classes (but not to motor vehicle liability). This is dealt with on the Form by reporting the whole of the gross premiums written and earned subject to class enhancement at lines 14 and 24 and


\(^{61}\) It has been suggested (and the repealed Guidance Note 9.1 indicated as such) that the anticipated FSCS levy in respect of business written during the financial year could be regarded as a levy, but the accepted view seems now to be that, particularly since the 2008 revisions to the system, this is not a premium levy but a levy for which premiums happen to be used as the basis of apportioning contributions between insurers.
adding 50% of those values in arriving at the sub-totals at lines 16 and 26. This requirement does not apply to a pure reinsurer that became a firm run-off prior to 31 December 2006 and whose Part 4A permission has not subsequently been varied to add back the regulated activity of effecting contracts of insurance.

(e) Actuarial health insurance is subject to a lower requirement (which may be regarded as in effect negative class enhancement) allowing one third of the normal margin to be required. The full amount of actuarial health premiums is reported at lines 15 and 25, and two thirds of this is deducted in arriving at the sub-totals at line 16 and 26. Actuarial health insurance is a shorthand term used on the Form to refer, in the context of general business, to health insurance business which meets the conditions set out in INSPRU 1.1.72R which are:

(1) the health insurance is written on a similar technical basis to that of life insurance
(2) the premiums are calculated on the basis of sickness tables according to the mathematical method applied in insurance
(3) a provision is set up for increasing age
(4) an additional premium is collected in order to set up a safety margin of an appropriate amount
(5) it is not possible for the insurer to cancel the contract after the end of the third year of insurance
(6) the contract provides for the possibility of increasing premiums or reducing payments even for current contracts.

3.5. The calculations so far described produce a base figure of gross adjusted premiums (sub-total I) at line 30 which is used to arrive at the premiums amount unless the financial year is not of 12 months duration, in which case an annualised figure will be calculated at line 31 and used. There is a peculiarity in the presentation of the mathematical process. The underlying Directive requires the gross adjusted premiums to be broken down into two portions, the first portion extending up to a threshold of €61.3 million and the second comprising the excess, and for 18% and 16% of these portions respectively to be calculated and added together. A presentation of this, using the Euro value of 85.02p which applies for regulatory purposes for the 12 months from 31 December 2013, for an insurer with gross adjusted premiums of £100 million gives the following:

<table>
<thead>
<tr>
<th></th>
<th>£'000</th>
<th>€'000 @ 85.02p</th>
</tr>
</thead>
<tbody>
<tr>
<td>18%</td>
<td>9,381</td>
<td>52,117</td>
</tr>
<tr>
<td>16%</td>
<td>7,661</td>
<td>47,883</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>17,042</strong></td>
<td><strong>100,000</strong></td>
</tr>
</tbody>
</table>

3.6. The calculation was, prior to 2004, presented in this manner and is still so presented in IPRU(FSOC). However, Form 11 is now designed so as to show 18% of the gross adjusted premiums at line 32 and deduct 2% of the excess over the threshold at line 33 in order to arrive at sub-total J (line 34). This is consistent with the way in which INSPRU is drafted, but

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62 Although the Form 11 presentation is consistent with INSPRU 1.1, this approach appears to be out of line with the underlying Directive. Article 16a of the First Non-Life Directive applies the two-thirds reduction to the 18% and 16% rates themselves, not to the premiums (and similarly, to the 26% and 23% rates and not to the claims) for this business. The result of the calculation could under some circumstances be different.
it is difficult to see what if any benefit adheres to turning the calculation around in this way. Mathematically it produces the same result, as the following demonstrates.

<table>
<thead>
<tr>
<th></th>
<th>£'000</th>
<th>£'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross adjusted premiums</td>
<td>100,000 @ 18%</td>
<td>= 18,000</td>
</tr>
<tr>
<td>€61.3 million @ 85.02p</td>
<td>52,117</td>
<td></td>
</tr>
<tr>
<td>Less balance of premiums</td>
<td>47,883 @ 2%</td>
<td>= 958</td>
</tr>
<tr>
<td></td>
<td></td>
<td>£17,042</td>
</tr>
</tbody>
</table>

3.7. Sub-total J is then multiplied by the fraction of net claims incurred divided by gross claims incurred to give the first result. This fraction is computed, following the Solvency I Directives, based on figures for the last three financial years. Where, as is normally the case, the reference period for the claims basis calculation is also three years, the figures at lines 41 to 45 will be the same as the figures at lines 21 to 25 on Form 12 which are discussed in paragraph 3.13 below. Net claims incurred are arrived at by deducting amounts recoverable from reinsurers from gross claims incurred. Recoverable amounts for accident year business can be taken as the sum of 22.12.4 and 22.16.4 for the three years. For underwriting year business, reinsurance recoveries on paid claims are the sum of 24.22.99-99 for the three years, while recoveries on outstanding claims will be based on the movement in 25.12.99-99 and 25.14.99-99 from the return three years previously to the present return, retranslating the former as necessary to reflect foreign exchange movements. Care is necessary though if a reinsurer’s share of claims management costs has been netted off in the revenue Forms. In that case, the figures will need to be adjusted to include also that share.

3.8. The fraction of net claims incurred divided by gross claims incurred which is applied to sub-total J (and which is stated at line 49 of the Form) in order to arrive at the premiums amount at line 50 may not be less than one-half or greater than 1. The restriction to one-half effectively limits the extent to which reinsurance is beneficial from a solvency point of view. If an insurer’s sole reinsurance protection is a 50% quota share and it increases this to 90% there is no reduction in the GICR at all. The upper limit of 1 covers the unusual situation where net claims exceed gross claims. Line 49 is required to be presented as a ratio (i.e. in the range from 0.50 to 1.00) rather than as a percentage.

3.9. The brought forward amount is of no practical relevance unless the GICR would otherwise be lower than for the previous year, although the relevant lines on Form 11 need to be completed in any event. Line 51 reports the provision for claims outstanding net of reinsurance and before discounting, save for those circumstances where discounting is expressly permitted on Form 15 (classes 1 and 2, annuities and pure reinsurers that went into run-off prior to 31 December 2006 and do not have permission under FSMA to effect contracts of insurance). If discounting adjustments under one or more of the exceptions have been included in line 51, supplementary note 1104 is required to describe the items that have been discounted. The figure to be included can be derived from Form 15 line 12 less Form 13 line 61. The brought forward amount at line 53 is the lower of the previous year’s GICR (Form 12.43.2) and the amount arrived at by multiplying the previous year’s GICR by the fraction of 11.51.1/11.51.2 (i.e. the proportionate movement in the provision for claims over the three years).

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62 Even where the ceded ratio is less than 50% a general insurer should be aware when contemplating additional reinsurance arrangements that the benefit in the solvency calculation under the premiums basis is, as a consequence of the mechanics of the calculation, not fully received until at least three years have elapsed. If the profile of claims is such as to cause a particularly unfortunate interplay with the brought forward amount, the benefit may never filter through to the GICR at all.
The greater of the premiums amount and the brought forward amount is stated at line 54 and carried forward to Form 12.

3.10. The rules also address the approach to be taken when the net outstanding claims brought and carried forward are both zero, which is of practical relevance when a book of business is fully reinsured. In this case, the requirement is to calculate the brought forward amount by reference to gross outstanding claims. The provision for gross outstanding claims is shown at line 52 of Form 11; this line will only include figures if both columns at line 51 indicate zero.

3.11. Some uncertainty can arise as to the position of the inputs to the brought forward amount where a business transfer has taken place. INSINU 1.1.66R, the rule requiring adjustment to premiums and claims in the event of a transfer, identifies the rules to which it applies, and INSINU 1.1.51R, the rule governing the calculation of the brought forward amount, is not among those rules. The brought forward amount should therefore be calculated on the basis of the GICR and net claims outstanding as they were stated in the previous return, rather than recalculating those inputs on an ‘as if’ basis. Paragraph 3.16 below describes the special case where comparatives are changed due to a significant change in the firm’s business occurring during the year. Even in this case, the brought forward amount is not changed.

3.12. The use of a second method of calculating the required margin, based on claims, is logical since the premiums formula fails to distinguish between adequate and inadequate premium rates. If two insurers are writing similar types of business but insurer B accepts twice as many risks as A while quoting 50% of A’s premium rates, there needs to be some mechanism for requiring B to maintain a larger buffer fund than A. This is achieved by specifying a claims-based formula, which will give a higher result than the premiums basis for an insurer with constant premiums where the loss ratio exceeds approximately 78%. However, since claims experience may vary dramatically from year to year without there being any deficiency in premium rates (e.g. where there is a catastrophe once every five or six years which can be absorbed by favourable underwriting results in the intervening years), smoothing is achieved by taking an average over a three-year reference period (or seven years if the insurer only underwrites storm, hail, frost or credit perils and risks associated therewith). An insurer which has not been in existence for three years will make the calculation over a one or two year reference period in its first two returns. The number of months in the reference period is stated at line 11: the gross claims incurred in the reference period calculated as sub-total E (line 29) are multiplied by 12 and divided by the number in line 11 in order to arrive at the annualised figure which is indicated at line 31 (sub-total F).

3.13. Lines 21 to 29 show the calculation of gross adjusted claims incurred in the reference period. Similar concepts to Form 11 apply in respect of transfers of business, contracts which have the legal form of insurance but which are not accounted for as such, class enhancement and actuarial health insurance. The following claims-specific points are relevant in completing these lines.

(a) All claims figures are net of salvage recoveries, recoveries from third parties and recoveries from other insurers (except for reinsurance recoveries), are gross of discounting and include claims management costs. Instruction 10 to Forms 11 and 12 explicitly requires “all direct and indirect costs related to the claims” to be included.

(b) Gross claims paid at line 21 represent the sum of 22.11.2, 22.14.2, 22.15.2, 22.18.2, 24.21.99-99 and 24.39.99-99 for the financial years within the reference period, with

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64 The formulation of INSINU 1.1.51R appears to be defective as it refers to the GICR for the prior financial year being multiplied by the ratio of the technical provisions for claims outstanding at the end and the beginning of that financial year, rather than those for the ‘financial year in question’, which implies that in the 2013 return, the 2012 GICR would be multiplied by the proportionate movement in outstanding claims between 1 January 2012 and 31 December 2012. This is not what the Instructions to Form 11 require, neither is it either logical or compliant with the Directive. It is logical to follow the Instructions to the Form.
figures for the earlier years retranslated where appropriate. These sources, and the others quoted below, can be taken from the category 001 Forms in Appendix 9.2.

(c) Claims outstanding carried forward for business accounted for on an underwriting year basis (line 22) can be derived as the sum of 25.11.99-99, 25.13.99-99 and 25.15.99-99.

(d) Claims outstanding carried forward for business accounted for on an accident year basis (line 23) is the sum of 22.11.3, 22.14.3, 22.15.3 and 22.18.3 for the current financial year.

(e) Claims outstanding brought forward for business accounted for on an underwriting year basis (line 24) can be derived as the sum of 25.11.99-99, 25.13.99-99 and 25.15.99-99 from the return for the financial year before the start of the reference period, retranslated as appropriate to reflect foreign exchange movements.

(f) Claims outstanding brought forward for business accounted for on an accident year basis (line 25) is the sum of 22.11.1, 22.14.1, 22.15.1 and 22.18.1 from the return for the first year of the reference period, retranslated as appropriate to reflect foreign exchange movements.

3.14. The annualised gross claims incurred figure is then subject to a mathematical process at lines 32, 33 and 39, which is similar to that applied at lines 32 to 34 of Form 11, save that a 26% factor is calculated and a deduction is made of 3% of the excess over €42.9 million. The resulting figure is then multiplied by the reinsurance ratio (Form 11 line 49) to arrive at the claims result (line 41). Line 42 states the higher of the premiums amount and the brought forward amount per Form 11, and the higher of lines 41 and 42 represents the GICR (line 43) which is taken to Form 1 line 31.

3.15. Where a difference arises between the figures reported on Forms 11 and 12 and the figures on Forms 21 to 25 because of transfers of business or the legal form issue, as discussed in points (a) and (b) of paragraph 3.4 above, a supplementary note (code 1105/1205) needs to be provided, explaining the amount and the reason (Appendix 9.1 paragraph 10(2)).

3.16. Any differences between the brought forward figures in column 1 and the carried forward figures in a previous return should be reported (Appendix 9.1 paragraph 7) in a separate supplementary note (code 1111/1211). A further supplementary note (1102/1202) is required to explain restatement of comparatives in the specific circumstances contemplated in INS PRU 1.1.71R. This rule states that where there has been a significant change in the business portfolio of the insurer since the end of a financial year (e.g. a line of business has been transferred to another firm), the gross adjusted premiums amount and the gross adjusted claims amount are to be recalculated to take account of the change. Where such a recalculation takes place, the comparatives in the following year’s return should reflect the result of this recalculation (although Instruction 6 to Forms 11 and 12 emphasises that the brought forward amount would not be recalculated).

3.17. In 2003 the FSA proposed the introduction of an enhanced capital requirement for general insurers. It was originally intended that the CRR of such an insurer would in time represent the higher of the ECR and the MCR; in most circumstances the ECR was expected to be higher. However, the initial introduction of the ECR was (and, as will be seen, has remained) ‘soft’, with insurers calculating the ECR and reporting it privately to the Regulator outside the return. The ECR is arrived at by applying prescribed factors to three different sets of base data, aggregating the results and deducting the equalisation provision. The three sets of data are:

(a) net premiums written by category of business;

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Adjustments to the formulae indicated for deriving claims figures in this and the subsequent sub-paragraphs will be needed if claims management costs are reported on the 20 series of Forms net of reinsurers’ share.
(b) net technical provisions (defined as unearned premiums net of deferred acquisition costs, outstanding claims and unexpired risks) by category of business; and

(c) assets by Form 13 heading.

3.18. The reason for deducting the equalisation provision is in order to enable the same definition of capital resources to be used for ECR as for MCR purposes, without distorting the ECR assessment by double-counting the impact of the equalisation provision, which is conceptually a capital requirement rather than a liability. The first two elements, referred to collectively as the insurance-related capital requirement (INSPRU 1.1.76R to INSPRU 1.1.79R), are based on net figures with no equivalent to the 50% limit on reinsurance deductions that applies to the calculation of the GICR on Forms 11 and 12: an insurer with heavy outward reinsurance will therefore have a relatively low ECR in relation to its gross risks. The third element, referred to as the asset-related capital requirement (INSPRU 2.2.10R to 2.2.16R), is based on admissible assets after the valuation and admissibility rules have been applied.

3.19. There is no equivalent, for the calculation of the ECR, of INSPRU 1.1.66R or 71R, which require adjustment of premiums for the purposes of calculating the GICR, where there has been, respectively, a transfer of business prior to the end of the financial year or a significant change to the business portfolio after the end of the financial year.

3.20. The main role of the ECR for a general insurer remains to provide an input to the pillar two assessment, and it has never become a ‘hard’ capital requirement. The annual submission is made on Form ECR1: as this does not form part of the annual return, it is considered separately in chapter 11.

4. Computing the long-term insurance capital requirement (Form 60) and resilience capital requirement

4.1. For most long-term insurance business, the LTICR is calculated by applying the formulae described in this part of this chapter, which are documented on Form 60. However, for some types of business, the rules require calculations to be performed on a general insurance basis using Forms 11 and 12, with the result of the calculation being transferred to Form 60. In this calculation, accounting conventions for general insurance business should be followed, but Instruction 3 allows reasonable approximations to be used. There are three types of business to which this applies:

(a) risks falling in general insurance business classes 1 and 2 which are written as part of a long-term insurance contract;

(b) contracts of insurance falling in long-term insurance business class IV (permanent health); and

(c) life protection reinsurance business written by a pure reinsurer or mixed insurer.

4.2. The LTICR is effectively the required margin of solvency for life business prescribed by the EU Directive, but articulated by the PRA in a very different way. There are some parallels with the GICR in that the margin is initially computed on gross figures and then reduced by a net/gross fraction, and that the net/gross fraction is restricted. However, there is also a fundamental difference in that whereas the GICR solvency is based on what in economic terms would be classed as a ‘flow’ concept (premiums for the year, claims over a three-year reference period), the LTICR is based on a ‘stock’ concept – the policies on the books at a given date.

4.3. The prescribed capital requirements vary as between the different classes of business. The fundamental requirement may be thought of as that for life assurance and annuity business (classes I and II), where the Directive requires the aggregation of two results, based respectively upon:
(a) 4% of mathematical provisions (equivalent to mathematical reserves in INSPrU), multiplied by the net/gross ratio of mathematical provisions for the last financial year, subject to a minimum of 85%; and

(b) 0.3% of capital at risk, defined as the amount payable on death less the mathematical provision for the main risk, multiplied by the net/gross ratio of capital at risk for the last financial year, subject to a minimum of 50%.

4.4. INSPrU however adopts a different terminology which refers to four components;

(a) the insurance death risk capital component (INSPrU 1.1.81R to 1.1.84AG);

(b) the insurance health risk and life protection reinsurance capital component (INSPrU 1.1.85R to 1.1.87G);

(c) the insurance expense risk capital component (INSPrU 1.1.88AR); and

(d) the insurance market risk capital component (INSPrU 1.1.89R).

4.5. In effect the EU first result, based on 4% of mathematical provisions, is broken down within INSPrU into an insurance expense risk capital component, based on 1% of adjusted mathematical reserves, and an insurance market risk capital component based on 3% of adjusted mathematical reserves. The EU second result corresponds to the insurance death risk capital component, while the insurance health risk and life protection reinsurance capital component stems relates specifically to the three types of business for which a long-term insurer is required to prepare Forms 11 and 12 as described above.

4.6. The insurance death risk capital component does not apply to classes IV (permanent health) V (tontines) and VI (capital redemption operations), or to life protection reinsurance business of pure reinsurers or mixed insurers. The normal factor is, in line with the Directive requirement indicated in the previous paragraph, 0.3% of the capital at risk multiplied by the net/gross fraction or 50% if higher. For business of a pure reinsurer to which the component is relevant, a lower 0.1% factor is applied. Furthermore, in the cases of classes I, II and IX a reduced factor of 0.1% can be applied to temporary insurance on death where the original term of the contract is three years or less, and 0.15% for temporary insurance on death where the original term of the contract is five years or less but more than three years. The calculation of the component, including the gross and net capital at risk, is dealt with at lines 11 to 15 of Form 60.

4.7. The insurance health risk and life protection reinsurance capital component is calculated by completing Forms 11 and 12 for class IV business, risks falling within general insurance business classes 1 and 2 and the life protection reinsurance business of pure reinsurers and mixed insurers. The basis of completing these Forms is as set out in the previous section, save that INSPrU 1.1.86R substitutes for condition (3) for the lower actuarial health rates to apply (paragraph 3.4 above) “either the reserves include a provision for increasing age, or the business is conducted on a group basis”. The figure computed at Form 12 line 43 will be taken to Form 60.21.5. However, by virtue of Instruction 2 to Forms 11 and 12, if the gross annual office premiums for the business in question in force on the valuation date do not exceed 1% of the total gross annual office premiums, Forms 11 and 12 need not be completed as long as it can be stated that the entry at Form 60.21.5 exceeds the amount which would have been obtained had the Forms been completed. In these circumstances, the method of estimating the entry at Form 60.21.5 together with a statement of the gross annual office premiums in force at the valuation date for the business in question must be given in a supplementary note (code 6001).

4.8. As indicated earlier, the insurance expense risk and market risk capital components are normally based on 1% and 3% respectively of adjusted mathematical reserves. Adjusted mathematical reserves represent gross mathematical reserves multiplied by the net/gross fraction (subject to the 85% minimum factor) but with certain exclusions. These exclusions are as follows.
(a) Mathematical reserves in respect of class V (tontines). Tontines are subject instead to a specific insurance expense risk capital component of 1% of the assets of the relevant tontine.

(b) For the purpose of the insurance expense risk capital component, amounts arising from classes III, VI and VII in respect of business for which the firm bears no investment risk and the allocation to cover management expenses in the contract does not have a fixed limit which is effective as a limit for a period exceeding 5 years from the commencement of the contract. Such business is subject, instead, to an insurance expense risk capital component of 25% of the relevant net administrative expenses in the preceding financial year. 66

(c) For the purpose of the insurance market risk capital component, amounts arising from classes III, VI and VII in respect of business for which the firm bears no investment risk. Such business does not give rise to an insurance market risk capital component, because the market risk is borne by the policyholders.

4.9. The insurance expense risk capital component is reported at lines 31 to 38 of Form 60 and the insurance market risk capital component at lines 41 to 48. The sum of the four components represents the LTICR, which is reported at line 51 and taken to Form 2 line 31.

4.10. A regulatory basis life firm – that is, a long-term insurer that is not a realistic basis life firm (see chapter 8 paragraph 6.3) – has also to calculate a resilience capital requirement and include this at Form 2 line 32. The resilience capital requirement is dealt with in INSPRU 3.1.10R to 3.1.26R, and it would be outside the scope of this booklet to cover it in detail. In essence, its purpose is to cover adverse deviation arising from the effect of market risk for equities, real estate and fixed interest securities on:

(a) the value of long-term insurance liabilities;
(b) the value of assets held to cover long-term insurance liabilities; and
(c) the value of assets held to cover the resilience capital requirement.

4.11. The resilience capital requirement does not explicitly address risks other those described in the previous paragraph. The scenarios used for the purpose of calculating the resilience capital requirement have to be described in paragraph 7 of the Appendix 9.4 valuation report (see chapter 8, paragraph 5.9).

66 There is no equivalent, for this element of the calculation, to the rule for general insurance requiring transfers of business to be dealt with as though the transferor insurer had never written the business and the transferee insurer had always written it, though such an approach would seem logical, and the authors are aware of at least one case where a proposal to adopt this approach was viewed sympathetically by the Regulator. An insurer seeking to apply such an interpretation should always discuss the matter with its PRA supervisor.
Chapter 4 – Assets

Having discussed in chapter 3 the capital resources requirement, the booklet proceeds in the present chapter to examine the regulatory value that can be placed on assets and reported in the return on Form 13 and which impacts on the capital resources which are compared with the requirement; liabilities will be considered in chapter 5. The subject matter of the present chapter has been broken down into an introduction (section 1), the basic valuation rules (section 2), asset admissibility (section 3) and market risk and counterparty exposure limits (section 4). The market risk and counterparty exposure limits and the list of admissible assets considered in section 3 do not apply to pure reinsurers, which instead apply “prudent person” investment principles. Derivative contracts, which can give rise to either assets or liabilities, are considered separately in section 5, together with quasi-derivatives and stock lending transactions.

1. Introduction (Form 13)

1.1. Assets are analysed on Form 13 into various headings to provide the PRA with the analysis that it considers it requires in order to fulfil its supervisory role. Unlike some other regulatory authorities, the PRA does not require detailed lists of investments to be submitted. It appears likely though, based on current draft materials, that Solvency II will see the introduction of such a requirement. Form 13 extends over three sheets: the basic analysis is set out on the first two sheets, and the third sheet provides an extended reconciliation to accounts values.

1.2. While the UK requirements do not, in general, either prescribe or prevent the holding of particular assets, there is an overall constraint imposed by INSINU 1.1.34R which requires an insurer to hold assets to cover its technical provisions which must:

(a) have characteristics of safety, yield and marketability which are appropriate to the type of business carried on by the firm;

(b) be diversified and adequately spread; and

(c) be of a sufficient amount, and of an appropriate currency and term, to ensure that the cash inflows from those assets will meet the expected cash flows from the firm’s insurance liabilities as they fall due.

1.3. Form 13 enables the general pattern of the investment policy, and its development over time, to be monitored. It also allows monitoring of compliance with other technical requirements, such as the INSINU 1.1.20R requirement to cover technical provisions and other general insurance and long-term insurance liabilities with admissible assets. As will be seen in section 4, concentrations of exposure to particular assets or counterparties may lead to a restriction being applied to the admissible value of the assets in question.

1.4. In various circumstances it will be necessary to prepare more than one Form 13, so a category of assets box has been included in the computer heading. Separate Forms are required for total long-term insurance business assets (category 10) and total other than long-term insurance business assets (category 1). While a composite clearly has to prepare both, and a pure general insurer only requires the latter, a pure life insurer (other than a mutual) will require a category 1 as well as a category 10 Form in order to distinguish its shareholder assets from its policyholder assets. In addition, a life insurer (whether composite or pure) which has two or more long-term insurance funds or groups of funds for which assets have been appropriated must, except in the case of internal linked funds, prepare a supplementary Form 13 for each such fund (or group of funds), classifying these as category 11, category 12, etc. These fund Forms will aggregate to the figures shown on the category 10 Form.

1.5. In a UK branch return the category 1, 10, 11, 12, etc. Forms 13 are prepared in the same way in respect of the assets relating to business carried on by the insurer through a branch
in the United Kingdom. For an external direct insurer making a UK branch return, three additional versions of Form 13 will be required showing respectively:

<table>
<thead>
<tr>
<th>Category</th>
<th>Code – other than long-term insurance business assets</th>
<th>Code – long-term insurance business assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets deposited under INSPRU 1.5.54R</td>
<td>2</td>
<td>6</td>
</tr>
<tr>
<td>Assets maintained in the United Kingdom</td>
<td>3</td>
<td>7</td>
</tr>
<tr>
<td>Assets maintained in the United Kingdom and the other EEA States.</td>
<td>4</td>
<td>8</td>
</tr>
</tbody>
</table>

1.6. The purpose of the category 2 and 6 Forms is to demonstrate compliance at the year-end with the deposit requirement that applies to such insurers (see chapter 3, paragraph 1.3). This deposit will also appear on the total and assets maintained Forms but will not be distinguishable as such. Category 3, 4, 7 and 8 Forms are required to enable the PRA to monitor compliance at the year end with INSPRU 1.5.48R, which requires the assets covering the technical provisions and representing the UK MCR of a non-EEA insurer to be kept:

(a) up to an amount at least equal to the technical provisions and the guarantee fund within the United Kingdom; and

(b) as to the remainder, within the United Kingdom and the other EEA States (although, in practice, in many cases all assets relating to the UK branch are maintained in the United Kingdom).

1.7. The headings that appear on Form 13 correspond closely with the asset disclosures required in the balance sheet prescribed for the accounts by Schedule 3 (although the analogy is less close for insurers preparing accounts under IFRS). Appendix A provides a line by line analysis of the Form, identifying the equivalent Schedule 3 format headings as well as commenting on the applicable valuation rules, admissibility and market risk and counterparty exposure restrictions considered later in this chapter. The main differences between Form 13 and Schedule 3 are as follows:

(a) Called up share capital not paid (asset item A) does not appear on Form 13 since this is not an admissible asset. This item is different from unpaid amounts on partly-paid shares which may form part of capital resources if a waiver is obtained.

(b) Intangible assets (asset item B) do not appear on Form 13 since these are specifically required to be deducted from capital resources by GENPRU 2.2.155R. Examples of such assets are given by GENPRU 2.2.156G as goodwill, capitalised development costs, brand names, trademarks and similar rights, and licences but the list should not be taken as exhaustive.

(c) Certain other headings are subdivided where different valuation considerations apply to particular items - for example “approved securities” at lines 45 and 47 differ from other debt securities in being outside the scope of the market risk and counterparty exposure limits. Other headings are broken down into due in 12 months or less or due in more than 12 months (other debtors at lines 76 to 79) or subject to a time restriction of one month or less or more than one month (deposits at lines 54 and 55).

67 The different considerations that apply in an EEA branch return are discussed in appendix E.
(d) Debtors arising under reinsurance operations are analysed into amounts relating to reinsurance accepted (line 74) and amounts relating to reinsurance ceded (line 75).

1.8. In two instances, Schedule 3 allows options as to whether an item is dealt with as an asset or as a deduction from liabilities. The reinsurers’ share of technical provisions may be deducted from gross technical provisions, and deferred acquisition costs may be deducted from the unearned premium provision. In the return, however, such optionality would not be appropriate, and a single treatment has been prescribed, although this differs between long-term insurance and general insurance business. In the case of long-term insurance business, the mathematical reserves on Form 14 are net of reinsurance and there is also a line (16) on Form 14 for the reinsurers’ share of claims outstanding which had fallen due for payment before the end of the financial year. Consequently, there can never be entries at lines 60 to 63 of the category 10 Form 13, while there can also never be an entry at line 85 since long-term insurance business deferred acquisition costs do not represent an admissible asset. For general insurance business, however, all technical provisions on Form 15 are required to be gross of reinsurance and deferred acquisition costs, and the reinsurers’ share of technical provisions and deferred acquisition costs can therefore only be included via Form 13. This general insurance business approach is consistent with the practice prescribed by the ABI SORP on the basis of the requirements of FRS 5. Gross presentation is also prescribed by IFRS 4, for those insurers reporting under this framework.

1.9. In a sense, the Form 13 classification should be the last step in the process since the valuation rules and restrictions of GENPRU and INSPRU have to be applied first, and only assets that survive this process fall to be included on the Form. Nevertheless, it is helpful to bear the classification in mind from the outset, given the need for insurers that prepare accounts under the Companies Act or IFRS to complete lines 91 to 102 to reconcile the grand total of admissible assets (line 89) to total assets per the accounts, and the fact that many insurers issue their accounts before completing the return.

1.10. In the case of an insurer that does not prepare external accounts under either the Companies Act or IFRS (for example, an external insurer preparing a global return), Instruction 16 to Form 13 requires lines 99-102 to be left blank. However it has been the practice of some such insurers to complete these lines (and their equivalents on Forms 14 and 15) to reconcile to the financial reporting framework under which they do report. The Regulator has not, to the authors’ knowledge, raised any objection to what seems a sensible practice. What would not be sensible would be to leave lines 99-101 blank but include a now meaningless total at line 102.

1.11. The analysis at lines 91 to 102 provides an indication of the thought process that is necessary in completing the Form. As with certain other topics discussed in this booklet, there are a number of steps to be tackled in a particular order. The following analysis assumes for initial clarity that there are no regulated related undertakings so that lines 94 to 96 will be blank: group situations are considered in chapter 10.

(1) Value assets in accordance with the insurance accounts rules or international accounting standards and include the total value so determined at line 102. The insurance accounts rules allow certain investments to be valued at either current value or amortised cost. In completing line 102, an insurer should mirror the treatment adopted in its accounts.

(2) Except in the case of a pure reinsurer (for which the prudent person investment principles may lead to disallowances—see paragraphs 3.5 and 3.6 below), ascertain whether there are any assets which are not on the list of admissible assets in Annex 7R to GENPRU 2. These assets should then be valued in accordance with the valuation rules of GENPRU 1.3 and any valuation difference taken to line 98.

The treatment of a pure reinsurer’s assets that fail to meet the prudent person investment principles is not clearly stated, perhaps because INSPRU 3.1.61AR is articulated as requiring a pure reinsurer to invest in a way that does comply. An asset that does not in practice comply should be classified as inadmissible by analogy with the definition of inadmissible assets in a group context for a regulated related undertaking that is a pure reinsurer by INSPRU 6.1.60R(2). This interpretation also seems consistent with the Handbook glossary definition of “admissible asset”.
Include the GENPRU 1.3 value of such assets (other than deferred acquisition costs for a life insurer which are dealt with separately under (4) below) at line 93.

(3) Include at line 101 any grossing up or netting down differences between the accounts and the return other than the reinsurers’ share of technical provisions for a long-term insurer.

(4) For long-term insurance business, include the reinsurers’ share of technical provisions at line 100 and deferred acquisition costs at line 99.

(5) For general insurance business, include any discounting adjustment for the reinsurers’ share of claims outstanding at line 100 (see section 4 of chapter 5).

(6) Include the book value of any investment in an ancillary services undertaking at line 97 as such investments have to be valued as zero on the Form (see paragraph 2.18 below).

(7) Apply the valuation rules of GENPRU 1.3 to the remaining assets of the insurer (see section 2 below), and take any difference resulting to line 98 (which may be positive or negative).

(8) Except for a pure reinsurer, apply the market risk and counterparty limits of INSPRU 2.1 to the assets that were admissible under step (2) (see section 4 of this chapter). The effect of any write-down is reported at line 92.

1.12. Lines 58 and 59 include assets held to match linked liabilities. A fuller consideration of linked business appears in chapter 8 section 2, but it is relevant to consider here the Form 13 treatment of assets backing linked business. Although the underlying assets will fall into the headings covered elsewhere on Form 13, they are required to be excluded from the relevant lines and brought together at lines 58 and 59; this follows the treatment in the Schedule 3 balance sheet. Line 59 deals with assets matching property-linked liabilities; this will cover inter alia assets within an internal linked fund – that is to say an account to which an insurer appropriates certain linked assets and which may be subdivided into units the value of which is determined by the insurer by reference to the value of those assets. It will also cover directly held assets, such as units in an authorised unit trust held to match policy benefits directly linked to that unit trust. An insurer may also link policy benefits to an approved index; assets held to meet index-linked liabilities are shown at line 58.

1.13. Assets represented by surplus units held within internal linked funds are, by definition, not matching liabilities in respect of linked benefits and therefore appear out of place at lines 58 and 59. Assets representing surplus units are not exempt from the market risk and counterparty exposure limits, regardless of where they are disclosed on Form 13.

1.14. A number of supplementary notes to Form 13 are prescribed. Some (1311 on restatement of comparatives and 1318 explaining entries in line 101) apply to both general and long-term business, and 1303 and 1320 can only apply to general insurance business due to their nature or the design of the return. With these exceptions, each required note disclosure has two code numbers, with the former relating to other than long-term insurance business (the category 1 Form) and the latter to long-term insurance business (the category 10 Form). The first three supplementary notes derive from Instructions 5, 6 and 7 to the Form and represent disclosure of the following specific assets where these are present within the figures disclosed on the Form:

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69 As discussed at paragraph 2.2, the seemingly academic exercise of applying the valuation rules to inadmissible assets, which follows from rule 9.10(a), is necessary in order to reflect the order of adjustments in the capital resources table in GENPRU 2 Annex 1R and on Form 3, and to prevent inconsistencies between Forms 3 and 13. It is expected to be rare in practice for significant valuation differences to arise on assets that are inadmissible.

70 In view of the general GAAP presumption of GENPRU 1.3.4R (see paragraph 2.5 below), one would not normally expect to see a presentation difference between the returns and the accounts in terms of grossing up or netting down.
(a) The aggregate value of those investments which are:

(i). unlisted investments falling within any of lines 41, 42, 46 or 48 which have been valued in accordance with the rules in GENPRU 1.3;  

(ii). listed investments falling within any of lines 41, 42, 46 or 48 which have been valued in accordance with the rules in GENPRU 1.3 and are not readily realisable;

(iii). units or other beneficial interests in certain collective investment schemes that are not UCITS Directive/FSMA-recognised schemes; and

(iv). reversionary interests or remainders in property other than land or buildings, together with a description of such investments (code 1301 and 1308).

A single figure with a simple description for each of the disclosure items will suffice.

(b) The aggregate value of those investments falling within lines 46 or 48 (debt securities and other fixed interest securities other than approved securities) which are hybrid securities (code 1302 and 1309). A hybrid security is defined by Chapter 11 of IPRU(INS) as “a debt security, other than an approved security, the terms of which provide, or have the effect that, or contain an option which if exercised by the issuer would have the effect that the holder does not or would not have an unconditional entitlement to payment of interest and repayment of capital in full within 75 years of the relevant date”.

(c) Amounts in respect of salvage or subrogation included other than at line 73 (code 1303). Line 73 is only to be used for such recoveries which fall to be classified as debtors arising from insurance operations. The repealed Guidance Note 9.1 indicated that a single aggregate figure was adequate disclosure, and that rights which had resulted in the insurer acquiring an asset which was admissible in its own right need not be included.

1.15. These three notes may facilitate identification of assets which are subject to greater levels of valuation uncertainty, and for which the insurer might be expected to apply valuation adjustments or reserves when determining the values to be reflected in the return.

1.16. The fourth note relates to netting. Paragraph 8 of Appendix 9.1 requires amounts due to and from the insurer to be shown gross except where netting is specifically permitted by paragraph 8(2). This provides that in calculating amounts due to or from the insurer, amounts due to (from) any person may, unless expressly provided otherwise, be included net of amounts which are due from (to) that person, provided that such amounts may be set off against each other under generally accepted accounting practice, on condition that a supplementary note to that effect (code 1304 and 1310) is included. There is no need to quantify the amounts offset. “Person” includes, here and elsewhere, bodies corporate and unincorporated associations; it is not permissible to regard amounts due through an intermediary as due to or from that intermediary. Generally accepted accounting practice in this area is defined (under UK GAAP; a similar principle prevails under IFRS) by FRS 5, paragraph 29 of which sets out three key tests, all of which must be satisfied before assets and liabilities can be offset:

(a) the insurer and the counterparty owe each other determinable monetary amounts which are denominated in the same currency or readily convertible.

71 The reference to GENPRU 1.3 in this and in the rule referred to in (ii) is redundant, since all assets and liabilities are valued in accordance with the rules in that section of the Handbook. In its previous incarnations, this rule had referenced a specific provision.
Chapter 4 – Assets

(b) the insurer has the ability to insist on net settlement and can enforce a net settlement in all situations of default by the counterparty

c) the ability to insist on net settlement is assured beyond doubt and can survive insolvency of the other party.

1.17. Supplementary notes 1305/1319, 1306/1312 and 1307/1313 stem from paragraph 11 of Appendix 9.1, and will be considered in section 4 of this chapter after the market risk and counterparty exposure limits and the concept of aggregate exposure have been addressed. Instruction 14 to the Form requires the inclusion of a supplementary note (code 1314/1316) indicating the amount of tangible leased assets included at line 80. The next supplementary note (code 1315/1317) provides particulars of any items included as “other assets” at line 83 of Form 13. Entries at this line will be rare. The repealed Guidance Note 9.1 indicated that it should only be used for items classified as other assets at item FV in the Schedule 3 balance sheet format. However, there would appear to be an exception in the case of deposits not subject to time restriction on withdrawal with a non-approved credit institution; these would be classified as cash at bank in the Schedule 3 accounts (asset item FIII) but do not qualify for inclusion at line 81 of Form 13 as the credit institution is not approved. 72

1.18. Three further notes do not have separate codes for general and long-term business. The need for a note to explain any changes to comparative figures (code 1311) was mentioned at paragraph 4.13 of chapter 2. Instruction 11 requires disclosure of any amounts included at lines 60 to 62 in respect of Insurance Special Purpose Vehicles (code 1320); as these lines do not apply to long-term business, this note is applicable only to general insurance. It is considered further at section 6 of chapter 7. Finally, Instruction 16 requires explanation of any amounts included at line 101 (code 1318). This line is the home for any other differences that do not fall within one of the earlier reconciling lines (e.g. resulting from different grossing up between the accounts and the return), hence the reference at the line to “(can be negative)”. 73

1.19. There are also specific provisions within INSPRU relating to the matching and localisation of assets which merit a brief reference even though these do not directly impact on the Form 13 disclosures. INSPRU recognises that fluctuations in foreign exchange rates may impact adversely on an insurer where it holds an open position in foreign currency. The overall constraint of INSPRU 1.1.34R would permit some currency mismatching of assets and liabilities, but (implicitly) only if sufficient excess assets are held to cover the exposure arising from such mismatching. INSPRU 3.1.53R imposes a mathematical requirement (which is not applicable, by virtue of INSPRU 3.1.54R to a pure reinsurer, or to assets held to cover index-linked or property-linked liabilities) for an insurer to hold admissible assets in a currency of an amount equal to at least 80% of its liabilities in that currency arising in connection with contracts of insurance. The non-credit equalisation provision 74 falls outside the scope of the matching requirement, and there is a de minimis provision in respect of assets in a currency whose value does not exceed 7% of the assets in other currencies. An asset is deemed to be in a currency if it is expressed in, or capable of being realised without exchange risk in that currency. Tests for determining the currency of a liability are set out in INSPRU 3.1.55R.

1.20. The matching provisions are complemented, for UK direct insurers, by the localisation requirements in INSPRU 1.1.30R. This rule requires the insurer to hold admissible assets necessary to satisfy to the matching requirement of INSPRU 3.1.53R:

(a) where the admissible assets cover technical provisions in pounds sterling, in any
EEA State; and

72 The rubric of line 83 of the Form actually states ‘approved institutions’; however that term is nowhere defined. The text used to include approved credit institutions, approved financial institutions and local authorities.
73 Other differences in the valuation of assets at line 98 can also be negative, although the Form does not explicitly state this.
74 The credit equalisation provision, which is a Directive requirement, is not exempted. INSPRU 3.1.53AG suggests that a firm may allocate the total credit equalisation provision to different currencies in proportion to the split by currency of the technical provisions for credit insurance business established in accordance with GENPRU 1.3.4R, but recognises that another allocation which the firm is able to justify as broadly appropriate may be used.
(b) where the admissible assets cover technical provisions in any currency other than pounds sterling, in any EEA State or in the country of that currency.

1.21. This Directive-derived rule does not apply to debts owed by reinsurers, to business carried on by a UK direct insurer outside the EEA or to marine, aviation and transport business. For the purposes of the rule:

(a) a tangible asset is to be treated as held in the country or territory where it is situated;

(b) an admissible asset consisting of a claim against a debtor is to be treated as held in any country or territory where it can be enforced by legal action;

(c) a security which is listed is to be treated as held in any country or territory where there is a regulated market\(^75\) on which the security is dealt; and

(d) a security which is not listed is to be treated as held in the country or territory in which the issuer has its head office.

2. The basic asset valuation rules

2.1. The Handbook approach to recognition and measurement of assets has three principal elements, which are dealt with respectively in this and the following two sections of this chapter of the booklet:

(a) valuation rules, founded on a basic rule at GENPRU 1.3.4R applying GAAP rules to recognition and measurement, except where specific provisions in INSPRU or GENPRU provide to the contrary (the exceptions applying principally in relation to investments);

(b) a list of admissible assets for insurers in Annex 7R to GENPRU 2, which does not apply to pure reinsurers (who are subject instead to “prudent person” investment principles); and

(c) rules on limitation of exposures to counterparties and asset classes.

2.2. Whilst it might appear that there is little point in applying valuation rules to an asset where that value is going to be excluded on grounds of inadmissibility or trimmed back as representing an excessive concentration, the order in which these three principles are applied is important to the logic of the calculation of capital resources. The impact of valuation differences and deductions appears at different places in that calculation. Valuation differences, if net positive, are an addition to core tier one capital, and if net negative are a deduction from tier one capital. Intangible assets and investments in own shares are also deducted from tier one capital. However other inadmissible assets, and asset values in excess of the counterparty and asset exposure limits, are deducted from the total of tier one and tier two capital. Adjustments for regulated related undertakings which are not insurance undertakings, and for ancillary services undertakings, are also made to total capital. In view of the operation of the limits on tiers of capital (which the PRA refers to as the “capital resources gearing rules”) described in chapter 3 of this booklet, it may readily be appreciated that a deduction or addition at the wrong stage in the calculation could have a significant impact on the total amount of capital that an insurer may recognise, and its compliance with some of the more complicated rules on mix of capital instruments.\(^76\)

\(^75\) The concept of a regulated market is considered in paragraph 4.19 of this chapter.

\(^76\) Thus, where an asset is inadmissible but the rules ascribe a higher value to it than GAAP does, the insurer’s tier one capital can be increased by the value adjustment, though the deduction from total capital due to inadmissibility is also correspondingly larger. This may seem counter-intuitive. The choice of accounting framework may also influence the result – it seems strange that life deferred acquisition costs, which are an inadmissible asset for an insurer preparing accounts under Schedule 3, turn into an intangible asset in the case of an insurer preparing accounts under IFRS and are deducted at an earlier stage in the calculation.
2.3. The position is further complicated in that the Forms on which assets and liabilities are shown in detail, Forms 13 and 15, still have some features inherited from older regulatory frameworks, in which valuation, admissibility and exposure limits were all bound up in a single set of valuation rules. The value at which an asset is shown on Form 13 may therefore reflect the net result of several adjustments reflected at different places on Form 3, and even on Forms 1 and 2.

2.4. The primary valuation rule is that of GENPRU 1.3.4R, which is equally applicable to liability, equity and income statement items. This provides that except where a rule in GENPRU or INSPRU provides for a different method of recognition or valuation, a firm must recognise the item and measure its value in accordance with whichever of the following is applicable to the firm (or as would be applicable if the firm were a company with its head office in the United Kingdom):

(a) the insurance accounts rules (i.e. Schedule 3);

(b) Financial Reporting Standards and Statements of Standard Accounting Practice issued or adopted by the Accounting Standards Board; and

(c) Statements of Recommended Practice, issued by industry or sectoral bodies recognised for this purpose by the Accounting Standards Board (in this context, the ABI SORP is clearly of direct relevance to insurers); or, alternatively,

(d) international accounting standards

2.5. GAAP principles will therefore apply in determining recognition or de-recognition of assets, and will define such matters as the netting of amounts due to and from the firm, the securitisation of assets and liabilities and leased tangible assets. GAAP will also apply in terms of initial valuation, unless an exception applies.

2.6. In the case of assets, the only items for which a different method of valuation is provided for by GENPRU are defined benefit pension scheme surpluses (which are required by GENPRU 9R(2)(a) to be derecognised, which will be recorded as a valuation adjustment) and investments, derivatives and quasi-derivatives by virtue of GENPRU 1.3.41R, with shares in, and debts due from, related undertakings having their own separate treatment by virtue of GENPRU 1.3.43R. All other assets, including for example land, buildings and immovable property rights, will therefore be valued on a GAAP basis rather than having individual valuation rules.

2.7. GENPRU 1.3.41R requires the provisions of GENPRU 1.3.14R to 1.3.34R to be applied in order to determine how to account for:

(a) investments that are, or amounts arising from the disposal of:
   (i). debt securities, bonds and other money and capital market instruments;
   (ii). loans;
   (iii). shares and other variable yield participations; and
   (iv). units in UCITS schemes, non-UCITS retail schemes, recognised schemes and any other collective investment scheme that falls within paragraph (1)(A)(d)(iv) of Annex 7R to GENPRU 2; and

(b) derivatives and quasi-derivatives.

2.8. GENPRU 1.3.41R is overridden by GENPRU 1.3.43R in the case of shares in, and debts due from, certain related undertakings which will be valued in accordance with GENPRU 1.3.45R to 1.3.51R rather than in accordance with GENPRU 1.3.14R to 1.3.34R.
2.9. The preferred approach of GENPRU 1.3 to investments is that these should be marked to market under GENPRU 1.3.14R: that is to say the valuation should be on the basis of readily available close out prices from independent sources (such as exchange prices, screen prices or quotes from several independent reputable brokers). GENPRU 1.3.16R states that in marking to market, a firm must use the more prudent side of the bid/offer spread unless it is a significant market maker in a particular position type and it can close out at the mid-market price.

2.10. An insurer with a conventional investment policy may well be able to mark all its investments to market. Where this is not possible, GENPRU 1.3.17R requires a mark to model approach to be adopted: marking to model is any valuation which has to be benchmarked, extrapolated or otherwise calculated from a market input. This approach is clearly seen as a riskier one to adopt, and GENPRU 1.3.18R to 1.3.25R specify a number of additional requirements which seem collectively intended to ensure that there is adequate testing and challenge of the model and awareness of the risks. Regardless of whether a mark to market or mark to model approach is adopted, independent price verification (the process by which market prices or model inputs are regularly checked for accuracy and independence) must be performed (GENPRU 1.3.26R). Consideration must be given under GENPRU 1.3.29R to 1.3.33R as to whether valuation adjustments or reserves are necessary, in relation for example to less liquid positions, or where a mark to model approach is adopted. The PRA has identified that adjustments may be necessary not only for more complex products but even for large portfolios of standard products, for example where a concentrated holding could not be readily disposed of at fair value. If a value different from the GAAP fair value is used in the PRA return as a result of these considerations, GENPRU 1.3.34R and 35G require the insurer to reconcile the amounts; the reconciling differences between the two values will be identified in supplementary note 0310. In addition, although valuation adjustments or reserves adjustments are made to the asset values on Form 13, disclosure of any such adjustments is made in supplementary notes to the two liabilities Forms, coded 1401 and 1501.

2.11. During 2013, the PRA expressed concern that insurers' assessment and quantification of valuation uncertainty might in some cases be insufficiently robust and complete. The PRA associated this observation with "poor standards of financial asset valuation governance and control which include insufficient independence in valuing assets, inadequate documentation of policies and procedures, poor control over valuation models (including limited understanding of model assumptions and limitations), and inconsistent governance between internally and externally managed funds."

2.12. Firms should therefore be aware that the PRA is prepared to challenge the reliability and prudence of valuations determined on a 'mark to model basis' and the compliance of the models with the detailed requirements of GENPRU 1.3. The PRA has indicated that firms who judge that valuation uncertainty is immaterial should be prepared to provide evidence to support this conclusion. In the return, supplementary notes 1401 and 1501 require an insurer also to disclose the methods and assumptions used to determine that no adjustment is required, if no adjustment is made.

2.13. The rules so far described do not apply in the case of shares in, and debts due from, related undertakings (essentially subsidiaries of the insurer and undertakings in which the insurer holds a participation, but, it should be noted, not parent entities or fellow subsidiaries of the insurer) that fall within GENPRU 1.3.43R for which, with the exception of ancillary services undertakings, what will be referred to as a "look through" valuation is required. This valuation is based on the underlying capital resources and CRR of the related undertaking. The look through rules apply to all regulated related undertakings and may in addition be applied to any other subsidiary undertaking, the shares of which a firm elects to value in accordance with GENPRU 1.3.47R. If an insurer does not so elect, the shares in such an unregulated subsidiary will be valued under the investment rules described above: the option to apply a look-through to a non-regulated related undertaking is only available for subsidiaries and not

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77 This election does not necessitate a formal election under SUP.
in respect of participations (unlike participations in regulated related undertakings for which look-through is required).

2.14. A regulated related undertaking is defined as a related undertaking which is:

(a) a regulated entity;\(^78\)
(b) an insurance undertaking which is not a regulated entity;
(c) an asset management company;
(d) a financial institution which is neither a credit institution nor an investment firm;
(e) a financial holding company;
(f) an insurance holding company; or
(g) a mixed financial holding company.

2.15. A key feature of this definition, which in turn relies on a number of defined phrases (so the Handbook glossary will need to be carefully studied), is that an undertaking does not necessarily need to be regulated to qualify as a regulated related undertaking. Any insurance or reinsurance undertaking (including an ISPV), wherever it may be incorporated and regardless of where it is regulated, will qualify under one of (a) and (b). This means that, for example, a corporate underwriting member of Lloyd’s is a regulated related undertaking of an insurer that owns it, notwithstanding that such entities are not themselves regulated by the PRA.

2.16. The look through concept applies to shares: GENPRU 1.3.44G states that debt due from such related undertakings will be included at its accounting book value. The look through concept essentially applies the principles of the Insurance Groups Directive to significant investments in insurers and other financial undertakings, and except in rare instances will result in a difference in approach between the treatment of a participation in a regulated related undertaking as an asset on Form 13 of the return, and its treatment as a component of a group on Forms 1 to 3, in what is referred to as an ‘adjusted solo’ calculation. This is discussed further in chapter 10 of this booklet. In a look through valuation, what is “looked through” to is:

(1) the relevant proportion of the regulatory surplus value of the related undertaking, defined as its total capital after deductions\(^79\) less its individual capital resources requirement, less

(2) the book value of the investments by the firm and its related undertakings in the tier two capital resources of the undertaking, and less

(3) if the undertaking is an insurance undertaking, its ineligible surplus capital and any restricted assets of the undertaking which have been excluded under INSPRU 6.1.41R (the technicalities of these requirements are considered further in chapter 10).

2.17. The “relevant proportion” referred to in (1) is based on the proportion of the total number of shares issued by the undertaking held, directly or indirectly, by the firm:\(^80\) however, if a related regulated undertaking that is a subsidiary is in deficit (i.e. its individual CRR exceeds

\(^{78}\) Defined as a credit institution, a regulated insurance entity or an investment firm and therefore excluding, inter alia, insurance intermediaries.

\(^{79}\) The regulatory surplus is net of amounts in excess of concentration limits, a puzzling requirement given that the capital adequacy calculation makes separate provision for the application of those limits in arriving at the adjusted solo capital resources on Form 3 (see section 2 of chapter 10).

\(^{80}\) This specification of GENPRU 1.3.49R(2) appears a little simplistic if there are different classes of shares with different entitlements, but the FSA considers this to be necessary to comply with Directive requirements.
the sum of its tier one and tier two capital resources), the full amount of the deficit will need to be provided. As it is not legitimate to report negative figures on Form 13, the subsidiary will be valued at nil on that Form, and the deficit provided for at line 22 of Form 14 or Form 15 as appropriate, with disclosure in a supplementary note (code 1403 or 1504). Certain of the adjustments to GAAP in applying the look through approach are separately identified on the Form 13 reconciliation. The capital resources requirement is shown as line 94, ineligible surplus capital and restricted assets at line 95 and inadmissible assets at line 96.

2.18. Investments in ancillary services undertakings are valued at accounting book value in accordance with GENPRU 1.3.4R (as explained at GENPRU 1.3.44G), however they are also required by GENPRU 2.2.255R to be deducted from total capital resources and therefore Instruction 4(c) to Form 13 requires them to be valued at zero on that Form (with the book value eliminated shown separately in the reconciliation section of the Form, at line 97). An ancillary services undertaking is defined as an ancillary insurance services undertaking, an ancillary banking services undertaking or an ancillary investment services undertaking. To concentrate on the first of these (the other definitions are analogous), an ancillary insurance services undertaking is defined as an undertaking whose principal activity consists of:

- owning or managing property;
- managing data processing services; or
- any other similar activity,

where this activity is ancillary to the principal activities of one or more insurance undertakings that are members of the group.

2.19. The rationale for valuing investments in such undertakings at zero is to prevent the building up of capital resources in such entities and their use for “regulatory arbitrage” purposes, although this could have been equally well have been addressed by requiring a “look-through” approach to be adopted. If the group’s properties are vested in such an undertaking, given the reference to “owning” in (a) above, it seems counter-intuitive for the value of those properties to be lost. An insurer is at liberty to apply for a waiver to regularise the situation.

3. Rules on asset admissibility

3.1. Following the initial determination of the value to be attributed to an asset under the rules, it is necessary to consider whether the asset is admissible for solvency purposes. GENPRU 2 Annex 7R provides a list of admissible assets for direct insurers (pure reinsurers are treated differently, as discussed at paragraphs 3.5 onwards below). Assets inadmissible by virtue of not appearing in the list are not given a value on Form 13, and are dealt with in the capital resources calculation on Form 3 as a deduction from total capital resources, unless the asset in question is an intangible asset or an investment in own shares in which case it is a deduction from tier one capital. The full list of admissible assets in GENPRU 2 Annex 7R is as follows:

- Investments that are, or amounts arising from the disposal of:
  - debt securities, bonds and other money and capital market instruments;
  - loans;
  - shares and other variable yield participations;
  - units in collective investment schemes falling within the UCITS Directive, non-UCITS retail schemes, recognised schemes and any other collective investment scheme where the insurer’s 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 insurer to enable it to monitor the investment risk being taken by the scheme;

(e) land, buildings and immovable property rights;

(f) an approved derivative or quasi-derivative transaction that satisfies the conditions in INSPRU 3.2.5R or an approved stock lending transaction that satisfies the condition in INSPRU 3.2.36R.

(B) Debts and claims:

(a) debts owed by reinsurers, including reinsurers' shares of technical provisions (but excluding amounts recoverable from an ISPV, unless a waiver is granted to permit recognition of such amounts);

(b) deposits with and debts owed by ceding undertakings;

(c) debts owed by policyholders and intermediaries arising out of direct and reinsurance operations (except where overdue for more than 3 months and other than commission prepaid to agents or intermediaries);

(d) for general insurance business only, claims arising out of salvage and subrogation;

(e) for long-term insurance business only, advances secured on, and not exceeding the surrender value of, long-term insurance contracts issued by the insurer;

(f) tax recoveries;

(g) claims against compensation funds.

(C) Other assets:

(a) tangible fixed assets, other than land and buildings;

(b) cash at bank and in hand, deposits with credit institutions and any other bodies authorised to accept deposits;

(c) for general insurance business only, deferred acquisition costs;

(d) accrued interest and rent, other accrued income and prepayments;

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

3.2. Where an asset potentially falls into more than one heading in the list, the PRA considers that the asset should be assessed as to admissibility according to the same rules as assets with similar economic substance. Consequently, units in collective investment schemes (which might be regarded as variable interest participations and money market schemes) can only be included in category (A)(d), while derivatives, quasi-derivatives (where assets having the effect of a derivative contract might be regarded as representing fixed interest securities and bonds) or stock-lending transactions can only be included in category (A)(f). Any units in collective investment schemes which have the effect of a derivative will be included in category (A)(f) rather than (A)(d). It is therefore a matter of considerable significance as to whether a particular asset is to be regarded as a quasi-derivative: the guidance in INSPRU 3.2 on this matter is considered in section 5 of this chapter.
3.3. GENPRU 2.2.253G indicates that the list of admissible assets was drawn up with the aim of excluding assets:

1. for which a sufficiently objective and verifiable basis of valuation does not exist
2. whose realisability cannot be relied upon with sufficient confidence
3. whose nature presents an unacceptable custody risk
4. the holding of which may give rise to significant liabilities or onerous duties.

These seem sensible criteria, though the list is in fact very closely aligned to the list of assets which the EU Insurance Directives allow to be used to cover technical provisions, rather than being carefully derived from first principles. The following may particularly be noted:

(a) intangible assets do not feature on the list, and neither do gold or commodities
(b) derivatives and quasi-derivatives are admissible only if they meet specified conditions
(c) premium debtors more than 3 months overdue are inadmissible (but there is no corresponding restriction on amounts recoverable from reinsurers)
(d) commission prepaid to agents and intermediaries is inadmissible
(e) deferred tax assets appear to be inadmissible (as these are not recoveries due from the tax authorities, but amounts contingent upon future taxable profits emerging)\(^{81}\)
(f) deferred acquisition costs are only admissible in relation to general insurance business
(g) recoveries due from ISPVs are not automatically admissible, and require the PRA’s consent by way of a waiver.

3.4. There is, however, one significant problem with the list, in that while some specific types of debt are admitted within (B) (and, where representing amounts receivable on disposal of investments, within (A)), there is no heading for “other” debtors, which would be disclosed in the Schedule 3 balance sheet as assets item E III and at lines 76 to 79 of Form 13. It seems strange that other debtors should be inadmissible when prepayments and accrued income are admissible. The anomaly has been drawn to the Regulator’s attention. It is therefore necessary to consider whether other debtors represent amounts due on disposal of investments, or loans, prepayments or accrued income and thereby preserve their admissible status.

3.5. A pure reinsurer is not subject to the list of admissible assets or the market risk and counterparty limits considered in the next section of this chapter. Instead, its investments need to comply with five prudent person investment principles, which article 34 of the Reinsurance Directive requires to be satisfied by the assets covering technical provisions, but which the PRA rules extend to all assets. The UK did not exercise the option in the Directive to extend this treatment to the assets of a mixed insurer covering technical provisions for reinsurance business.

3.6. The five principles are set out in INSPRU 3.1.61AR and are as follows:

1. The assets must take account of the type of business carried on by the firm, in particular the nature, amount and duration of expected claims payments, in such a

\(^{81}\) Although the deficit reduction amount in respect of a defined benefit pension scheme is specifically permitted to be recognised net of deferred tax.
way as to secure the sufficiency, liquidity, security, quality, profitability and matching of its investments.

2. The firm must ensure that the assets are diversified and adequately spread and allow the firm to respond adequately to changing economic circumstances, in particular developments in the financial markets and real estate markets or major catastrophic events. The firm must assess the impact of irregular market circumstances on its assets and must diversify the assets in such a way as to reduce such impact.

3. Investment in assets which are not admitted to trading on a regulated financial market must be kept to prudent levels.

4. Investment in derivatives and quasi-derivatives must contribute to a reduction in investment risk or facilitate efficient portfolio management and such investments must be valued on a prudent basis, taking into account the underlying assets, and included in the valuation of the firm’s assets. The firm must avoid excessive risk exposure to a single counterparty and to other derivative or quasi-derivative operations.

5. The assets must be properly diversified in such a way as to avoid:
   - excessive reliance on any one asset, issuer of group of undertakings
   - accumulations of risk in the portfolio as a whole.

   Investments in assets issued by the same issuer or by issuers belonging in the same group must not expose the firm to excessive risk concentration.

The diversification requirement of (5) does not apply to government bonds.

3.7. The rule does not contemplate that a pure reinsurer might hold assets that do not conform to these principles, and the disposition of such assets in the capital calculation. However, intangible assets and investments in own shares of pure reinsurers must in any case be deducted from tier one capital on Form 3, as pure reinsurers are not exempt from this requirement. It would appear sensible (and consistent with the requirements applicable in group solvency calculations) to regard these and indeed any other asset that does not comply with the principles as inadmissible when reporting on Form 13.

4. Market risk and counterparty exposure limits

4.1. Exposure limits have long been a feature of the UK regulatory framework for insurers. These limits are primarily imposed to encourage insurers to maintain a prudent spread of assets. In normal circumstances an insurer is free to invest its assets as it chooses, subject to the general constraint provided by the requirement of INSIPRU 1.1.34R with respect to matching of assets and liabilities (see paragraph 1.2 above). However, by limiting the extent to which certain assets can contribute to capital resources by reference to defined yardsticks, the rules introduce a more specific incentive for an insurer to avoid placing too much at risk in a particular investment. The rules have been refined over the years, and have increasingly concentrated upon economic exposure to a counterparty or an asset class, rather than purely the direct holding of an asset by an insurer. The quantitative limits do not, however, apply to pure reinsurers, to which the prudent person principles discussed in the previous section apply.

4.2. The limits are dealt with as part of the credit risk chapter of INSIPRU. INSIPRU 2.1 not only prescribes quantitative limits but also provides a general prudential obligation in INSIPRU 2.1.8R which states:
“Taking into account relevant risks, a firm must restrict its counterparty exposures and asset exposures to prudent levels and ensure that those exposures are adequately diversified.”

4.3. Also relevant is INSFRU 2.1.20R, which requires a firm to take reasonable steps to limit its exposure to one counterparty or group of closely related classes, or to one asset or class of identical assets, to a level where, if a total default were to occur, the firm would not become unable to meet its liabilities as they fall due.

4.4. It is quite possible that a particular exposure may be within the granular quantitative limits but in breach of INSFRU 2.1.8R because of the quality of the counterparty, or in breach of INSFRU 2.1.20R because of the aggregate exposure to a class of assets. These two rules are also of relevance to reinsurance exposures, which fall outside the scope of the detailed quantitative limits (though some evidential provisions exist and are considered in chapter 7).

4.5. Although there are some restrictions relating to assets, the emphasis of INSFRU is very much on counterparty exposures. A counterparty is defined by the Handbook glossary as being, in relation to an insurer:

(a) any one individual;

(b) any one unincorporated body of persons;

(c) any company which is not a member of a group;

(d) any group of companies, excluding for the purpose of INSFRU 2.1 any companies in the group which are subsidiary undertakings of the insurer and which fall within GENPRU 1.3.43R; and

(e) any government of a State, together with all the public bodies, local authorities and nationalised industries of that State,

in which the insurer, or any of its subsidiary undertakings, has made investments or against whom or in respect of whom it or any of its subsidiary undertakings has rights or obligations under a contract entered into by the insurer or any of its subsidiary undertakings. The quantitative limits are applied to the aggregate counterparty exposures to each member of a group of closely related persons. Under INSFRU 2.1.40R, a group of persons is deemed to be closely related where there are two or more persons who are deemed to constitute a single risk because (unless it can be shown otherwise) there is a control relationship (based on parent/subsidiary/fellow-subsidiary or the equivalent relationship with a natural or legal person) or they are so interconnected that, if one of them were to encounter financial problems, the other would be likely to encounter repayment difficulties.

4.6. Counterparty exposure is defined by INSFRU 2.1.9R as the amount by which the firm’s capital resources would reduce if a counterparty were to fail to meet its obligations (either to the firm or to any other person) and if simultaneously securities issued or guaranteed by the counterparty were to become worthless. The impact on capital resources must take into account not only the amount of loss resulting from the firm’s direct exposures but also from exposures held by any of its subsidiary undertakings and synthetic exposures arising from derivatives or quasi-derivatives held or entered into by the firm or any of its subsidiary undertakings. This explains the exclusion of subsidiary undertakings from part (d) of the definition of counterparty: exposures to subsidiaries do not need to be restricted because there is a look through to the subsidiaries’ own counterparty exposures. While this is internally consistent, and works well enough in the case of a subsidiary for which a look

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82 For all purposes of the Handbook other than INSFRU 2.1, all companies within the group which are subsidiary undertakings of the insurer are excluded from the definition of “counterparty” regardless of whether these do or do not fall within GENPRU 1.3.43R.

83 The recapitalisation of several banks by HM Treasury led to questions as to whether exposure by insurers to entities which have HM Treasury as a common shareholder should treat those entities as closely related for the purposes of INSFRU 2.1. The Regulator reached a conclusion that the entities are not considered closely related for this reason alone.
through valuation is being performed anyway (e.g. because it is a related regulated undertaking) it appears anomalous in the context of a subsidiary which does not fall within GENPRU 1.3.43R and which is being valued on a mark to market basis. Although a direct counterparty exposure limit has to be applied to the investment in shares of a subsidiary undertaking that is not valued on a look through basis by virtue of the definition of counterparty, a look through to underlying counterparty exposures of such a subsidiary is also required.

4.7. The yardstick figure by reference to which large counterparty exposures are judged is known as the “business amount.” Historically, there were separate yardsticks for general and long-term business, and the terms ‘general business amount’ (or GBA) or ‘long-term business amount’ (LTBA) are still sometimes encountered in the market. The business amount is a global figure, which can be applied in a branch return. It is defined by INSPRU 2.1.22R(4) as the sum of:

1. the firm’s total gross technical provisions excluding, in the case of a life company, technical provisions in respect of property-linked liabilities or index-linked liabilities (except that where the linked contract includes a guarantee of investment performance or some other guaranteed benefit, the technical provisions in respect of the guaranteed element are included)

2. the amount of its other liabilities (except those included in the calculation of capital resources)

3. such amount as the firm may select not exceeding the amount of the firm’s total capital after deductions as calculated at stage M of the table of capital resources, or if higher:
   (i). in the case of a firm carrying on general insurance business, the amount of its general insurance capital requirement
   (ii). in the case of a firm carrying on long-term insurance business, the amount of its long-term insurance capital requirement and the amount of its resilience capital requirement.

4.8. Due to the logic of the calculation, the figure for total admissible assets less linked assets provides in many cases a ready indicator for the business amount, provided that the linked assets do not include amounts covering guaranteed benefits. The variation to the formula applicable to an insurer performing an adjusted solo calculation is explained in chapter 10.

4.9. INSPRU 2.1.4R(2) states that if a firm carries on both long-term insurance business and general insurance business, INSPRU 2.1 applies separately to each type of business. The application of the limits to a composite is not self-evident from the text, and the following explanation is derived from individual guidance communicated in the past by the FSA to a particular firm. While INSPRU requires a composite insurer to identify separately the assets attributable to its general business and its long-term insurance business (i.e. the split between the category 1 and category 10 Form 13s), an insurer can choose how to allocate its other than long-term insurance business assets between its general insurance business and long-term insurance business and must separately calculate its capital resources to meet its CRRs for general insurance business and long-term insurance business by reference to its resources so allocated. When stage L (deductions from total capital) of the calculation in the table of capital resources is applied, this needs to be done separately for general insurance business and long-term insurance business by reference to the assets as so allocated. This means that any other than long-term insurance business assets allocated towards the long-term insurance business amount will be restricted by reference to the business amount determined in respect of long-term insurance business rather than that determined in respect of general insurance business. As there is often a significant difference

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84 Historically, there were separate yardsticks for general and long-term business, and the terms ‘general business amount’ (or GBA) or ‘long-term business amount’ (LTBA) are still sometimes encountered in the market.
85 The variation to the formula applicable to an insurer performing an adjusted solo calculation is explained in chapter 10.
86 For example, care should be taken when considering index-linked annuities, which commonly include a provision that if the referenced cost of living index falls, the amount payable will not; this represents a guaranteed benefit.
in the quantum of the two figures, this is an interpretation of considerable importance, and it is disappointing that this was never incorporated into INSPRU as general guidance.

4.10. Having computed the business amount or amounts, particular exposures can be compared with the prescribed percentages of the business amount. Any excess will give rise both to a deduction from total capital resources which will be reported at Form 3 line 74 and to a reduction in the asset values reported on Form 13. The write down will normally be dealt with by reducing the value of the asset in question on Form 13; however, if the deduction is more than the value of the asset held (e.g. because there is a restriction on deemed exposure arising through a derivative), or it relates to one of the aggregate tests considered in paragraph 4.21 below, the write down will be reported at line 87. If an affected asset for a life company is classed as partly a shareholder asset and partly a policyholder asset, then the effect is apportioned over the category 1 and category 10 Forms 13 in proportion to the unrestricted value of the asset attributed to each: a similar principle should be applied if an insurer has more than one long-term insurance business fund for which assets are separately appropriated and a reduction is required that will affect more than one fund.

4.11. Not all asset exposures are subject to the market risk and counterparty concentration restrictions. The following are exempt by virtue of INSPRU 2.1.33R and INSPRU 2.1.34R, and are therefore left out of account when determining exposure to an asset class or to a counterparty:

(a) premium debts;
(b) advances secured on, and not exceeding the surrender value of, long-term insurance contracts of the firm;
(c) rights of salvage or subrogation;
(d) deferred acquisition costs;
(e) assets held to cover index-linked liabilities or property-linked liabilities, except that where the linked contract provides guarantees of investment performance or other guarantees, the limits apply to assets held to cover that guaranteed element
(f) money due from, or guaranteed by, a zone A country (see paragraph 4.14);
(g) an approved security;
(h) a holding in a collective investment scheme falling within the UCITS Directive; and
(i) debts arising from reinsurance ceded and the reinsurers’ share of technical provisions (this last, however, must still be considered in connection with compliance with INSPRU 2.1.20R).

4.12. Other assets for which there is no limit specified are not subject to an asset class limit though should still be considered when determining whether exposures to counterparties need to be restricted. Exposures to subsidiaries valued on a look through basis are however exempt by virtue of the definition of “counterparty”.

4.13. The phrase “approved securities” in the seventh exemption refers to a range of assets that are seen as so secure that it is reasonable for the exposure restrictions not to apply. The current definition covers:

(a) any securities issued or guaranteed by, or the repayment of the principal of which, or the interest on which is guaranteed by, and any loans to or deposits with any

87 Amounts due from a cedant may also be exempt if they represent premium debts.
The correct use of definitions is important to the application of these requirements. The definition of “approved financial institution” in the above list is restricted to the European Central Bank, central banks of EEA States and certain supra-national institutions and excludes normal banks which fall within the separate definition of “approved credit institution” if they are authorised in the EEA, and are subject to concentration restrictions. Restrictions also apply to securities issued by Governments outside Zone A. Zone A is also relevant to the sixth exemption. The term was originally adopted by the Basel Committee on Banking Supervision and has been written into European Directives. Zone A may be described as follows:

(a) According to the Handbook glossary definition, Zone A constitutes:

(i). all EEA Member States;

(ii). all other countries which are full members of the Organisation for Economic Cooperation and Development (OECD) (i.e. currently Australia, Canada, Chile, Israel, Japan, South Korea, Mexico, New Zealand, Switzerland, Turkey and the United States of America); and

(iii). those countries which have concluded special lending arrangements with the International Monetary Fund associated with the Fund’s general arrangements to borrow (Saudi Arabia is the only current non-OECD member state with such an associated credit arrangement).

(b) Countries not in Zone A include Brazil, China, India, Indonesia and South Africa, which have a programme of ‘enhanced engagement’ with the OECD but are not members, and Colombia and Russia which are negotiations for OECD membership.

(c) The status of external territories of Zone A countries needs to be considered case by case, as they may be included within a country’s membership of the EEA or OECD. According to a Declaration made by the UK Government, the application of the OECD Convention to which it is signatory extends to the Channel Islands, the Isle of Man, Gibraltar and Bermuda.

(d) The definition of Zone A includes a ‘sin-bin’ provision, whereby any country which reschedules its external sovereign debt is excluded from Zone A for five years. An insurer should consider whether any countries to which it has exposure fall into this category, in view of the difficulties suffered by a number of countries during the global financial crisis.

4.15. The application of the concentration restrictions can be broken down into counterparty limits, aggregate limits on certain types of counterparty exposures and asset limits. INSPRU 2.1.22R(3) concentrates on counterparty exposures, and there are only four asset limits:

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88 Government intervention in 2008 in certain countries to support certain institutions in the banking sector could result in exposures to those institutions being elevated to the status of “approved securities”. However, because of the different forms this support may take, the situation will need to be considered on an institution by institution basis. Mere ownership of shares would not of itself provide this status.


90 It would be prudent to regard the debt restructing of Greece as excluding it from Zone A.
4.16. There are three sets of limits prescribed by INSPrU 2.1.22R(3) for different types of counterparty (or group of closely connected counterparties as described at paragraph 4.5 above):

(a) Where the counterparty is an individual or an unincorporated body of persons, there is an overall limit of 1% of the business amount and a sub-limit of ¼% of the business amount for the part of the exposure resulting from unsecured debt.

(b) Where the counterparty is an approved counterparty there is a limit of either 5% or 10% of the business amount for exposure not arising from short term deposits made with an approved credit institution, and a limit of 20% of the business amount (or £2 million if larger) for the whole exposure. Exposure to covered bonds is excluded from these limits, and is subject to a separate 40% limit.

(c) Where the counterparty does not fall into (a) or (b), there is an overall limit of 5% of the business amount for counterparty exposure, with a number of sub-limits:

(i). 1% of the business amount for exposure arising from unsecured debt in respect of a counterparty that is not a regulated institution.

(ii). 2½% of the business amount for exposure arising from unsecured debt in respect of a counterparty that is a regulated institution.

(iii). Subject to (iv), 1% of the business amount for exposure arising from shares, bonds, debt securities and other money market 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.

(iv). The sub-limit in (iii) is increased to 5% for exposure arising from debt securities (other than hybrid securities) issued by the same regulated institution.

4.17. It is not clear from the current text of the rules whether the categories in (i)/(ii) and (iii)/(iv) are intended to be mutually exclusive, as there is no Handbook definition of ‘debt’. The former articulation of the rules prior to the issue of PRU made it clear that there was mutual exclusivity between these categories, but this clarity was lost, without explanation, when the previous rules and guidance were replaced. The distinction is important as explained in paragraph 4.21 below.

4.18. In (c), the sub-limits need to be applied first, so that for example any equities not dealt in on a regulated market would be restricted by reference to the 1% limit of (iii), and only the amount within this limit would be used in determining whether the 5% overall limit had been exceeded: the 5% overall limit cannot be used to reinstate exposure in excess of the 1% limit.
4.19. The Handbook glossary definition of “regulated market” has a basic element relating to such markets within the EEA as defined in the Markets in Financial Instruments Directive: a list of such markets is maintained on the European Commission’s website (currently under the Securities section of its Internal Market pages). For the purposes of INSPIR and IPRU(INS) however the definition is extended to apply to a market situated outside the EEA which is characterised by the fact that it meets comparable requirements to those specified by the Directive, and the financial instruments dealt in it are of a comparable quality to those in a regulated market in the United Kingdom.

4.20. The “5% or 10%” limit in respect of exposure to an approved counterparty (except for short term deposits with an approved credit institution) is a Directive-derived principle. In essence the limit of 5% of the business amount can be increased to 10% provided that the exposures which are recognised at more than 5% of the business amount do not in the aggregate exceed 40% of the business amount. Thus if an insurer had counterparty exposure of 10% of the business amount to each of four approved counterparties, each of the 10% would be fully eligible as they did not in aggregate exceed 40% of the business amount. If there was also a 10% exposure to a fifth counterparty, that would be restricted to 5%. However if there were three at 10%, one at 8% and one at 7% of the business amount, the logic of the rule would still restrict the fifth to 5% as otherwise the 40% limit would be exceeded.

4.21. The following aggregate counterparty limits are imposed by INSPIR 2.1.22R(3):

(a) 5% of the business amount for all unsecured debt due from counterparties falling into (c)(i) and (ii) of paragraph 4.16 above.

(b) 10% of the business amount for all instruments due from counterparties falling into (c)(iii) and (iv) of paragraph 4.16 above or 4.15(d) of paragraph 4.15 above.

(c) 5% for the aggregate of all counterparty exposures arising from unsecured loans other than those due from approved counterparties.

4.22. The drafting here seems to be somewhat muddled: it is far from clear what the distinction is between unsecured debt under (a) and unsecured loans under (c) (other than that the latter includes loans due from individuals), as neither ‘debt’ nor ‘loan’ is a defined term, and the introduction of the limit under (c) was not accompanied by explanatory text. Neither is it clear whether a ‘debt security’ (which is a defined term) is included within the definition of ‘debt’ or ‘loan’ for this purpose, since a security may be unsecured within the narrow interpretation of that term in INSPIR 2.1.22R(7) (which explicitly applies only in respect of (a)), leaving room for doubt as to whether a more relaxed interpretation applies in respect of instruments not within that scope. It is also unclear why these aggregate limits include exposures to regulated institutions (a departure from previous practice), and why reversionary interests do not have to be taken into account in the 10% limit, as was once the case.

4.23. Where the whole or any part of a counterparty exposure is guaranteed by a credit institution or an investment firm subject either to the Capital Adequacy Directive or supervision by a third-country supervisory authority with a Capital Adequacy Directive-equivalent regime, or is adequately mitigated by a credit derivative, INSPIR 2.1.36R allows the firm to treat that exposure, or that part of the exposure which is so guaranteed or mitigated, as an exposure to the guarantor or derivative counterparty, rather than to the original counterparty. Whether it is advantageous to do so in any given case depends upon the extent to which the counterparty exposure limit for the original counterparty and the guarantor or derivative counterparty remains unutilised. A guarantee or letter of credit will only provide this option if it is direct, explicit, unconditional and irrevocable (INSPIR 2.1.27R). Similarly, where a firm has rights over collateral in respect of a counterparty exposure, and the assets constituting that collateral would, if owned by the firm, be admissible assets and would not themselves breach the INSPIR 2.1.22R limits, the firm may deduct the value of the collateral in determining its counterparty exposure and instead treat the exposure as an exposure to the collateral (INSPIR 2.1.35R and INSPIR 2.1.9R(5)).
4.24. The articulation of the rules on guarantee and collateralisation is at times less than clear, and it is left to the reader to deduce how the counterparty limits and the ability to ‘look through’ to the collateral or the guarantor, interplay. For debts that fall within INSPRU 2.1.33R(3)(i), it is clear from INSPRU 2.1.22R(7) that debt is only considered secured if and to the extent that it is guaranteed or collateralised in accordance with these rules. Any excess is unsecured. For exposures that do not fall within INSPRU 2.1.33R(3)(i), the narrow definition of ‘secured’ set out in INSPRU 2.1.22R(7) does not apply. However, the FSA has stated in correspondence the principle that a firm should be in no better position in terms of capital resources by holding an asset as collateral, than it would be if it enforced the collateral in settlement of the debt and owned the asset. Accordingly firms need to approach the application of these rules with caution, if seeking to rely upon the counterparty limits for secured debt rather than looking through to the security.

4.25. The final supplementary notes to Form 13 can be considered following on from the above discussion. The first requirement (code 1305 and 1319) is to disclose:

(a) the maximum extent to which, in accordance with any investment guidelines operated by the insurer, it was permitted to be exposed to any one counterparty during the financial year in question;

(b) the maximum extent to which, in accordance with such guidelines, it was permitted to be exposed to any one counterparty, other than by way of exposure to an approved counterparty, during the financial year in question; and

(c) an account of any occasions during the financial year on which either of those amounts was exceeded.

4.26. While an insurer would hope to have nothing to report under (c), the absence of satisfactory (or any) limits under (a) and (b) would suggest that the insurer was not complying with the systems and controls requirements in SYSC 15. The exposure figures, for this purpose, should be taken as the figures before any market risk and counterparty restrictions are applied.

4.27. Supplementary note 1306 and 1312 is required to disclose the amount and the nature of the held assets, for any counterparty exposure which is subject to any of the limits in INSPRU 2.1.22R(3) (i.e. not exempted under INSPRU 2.1.33R or 34R) and which exceeded at the end of the financial year, for long term insurance assets and other assets respectively:

(a) 5% of the sum of its base capital resources requirement and its long-term insurance liabilities, excluding property-linked liabilities and net of reinsurance ceded; or

(b) the sum of €20,000 and 5% of its general insurance business liabilities net of reinsurance ceded.\(^{91}\)

4.28. Supplementary note 1307 and 1313 discloses the aggregate value of any fully secured rights to which INSPRU 2.1.35R or INSPRU 2.1.36R and 2.1.37R relates, in other words where a debt has either been treated as secured, or an asset or counterparty exposure has been replaced for the purposes of applying the limits by an exposure to collateral or to a guarantor. Paragraph 5.4(24) of the repealed Guidance Note 9.1 indicated that a single aggregate figure is sufficient disclosure.

5. Derivatives, quasi-derivatives and stock-lending transactions (Form 17 and rule 9.29)

5.1. European Directives allow derivatives to be used to cover technical provisions where they are effected for the purposes of efficient portfolio management or reduction in risk. However, the UK applies a more comprehensive framework for derivatives and similar arrangements,

\(^{91}\) This threshold has the potential to require excessive disclosures in the case of insurers that are well capitalised in relation to their liabilities.
and as has generally been the UK's approach to the Insurance Directives, applies them to the whole of a direct insurer’s assets rather than only those covering technical provisions.

5.2. As was explained in section 3, a derivative, quasi-derivative or stock-lending transaction may only be assessed for admissibility as an asset in that capacity, notwithstanding that it may also be capable of description as another category of admissible asset. The provisions setting out the conditions for acceptance of derivatives, quasi-derivatives or stock-lending transactions as an admissible asset of a direct insurer are set out in INSPRU 3.2. It should also be noted that similar conditions apply to derivatives in linked funds; if these are not all met the use of the derivative is prohibited. Pure reinsurers are outside the scope of INSPRU 3.2 and apply the prudent person investment principles as described in section 3.

5.3. A derivative is defined by the Handbook glossary as a contract for differences, a future or an option. A future is defined as the investment, specified in article 84 of the Regulated Activities Order, which is in summary rights under a contract for the disposal of a commodity or property of any other description under which delivery is to be made at a future date and at a price agreed on when the contract is made. An option is defined as the investment, specified in article 83 of the Regulated Activities Order which is an option to acquire or dispose of:

(a) a designated investment (other than an option)
(b) currency of the United Kingdom or any other country or territory
(c) palladium, platinum, gold or silver
(d) an option to acquire or dispose of an option specified in (a), (b) or (c).

5.4. A contract for differences, referred to in this definition, is the investment specified in article 85 of the Regulated Activities Order which is in summary rights under a contract for differences (an unhelpful circularity in the wording), or any other contract the purpose or pretended purpose of which is to secure a profit or avoid a loss by reference to fluctuation in the value or price of property of any description or an index or other factor designated for that purpose in the contract, or a derivative instrument for the transfer of credit risk.

5.5. Quasi-derivatives are arrangements which take some other legal form but which have the characteristics of derivatives, and are generally dealt with together with derivatives. Stock lending transactions are discussed further below.

5.6. The INSPRU rules relating to derivatives and quasi-derivatives impact upon the information included in the return in a number of different ways.

(a) If a derivative instrument or quasi-derivative meets the conditions of INSPRU 3.2.5R to be approved, it can give rise to an admissible asset which will be included at line 44 of Form 13.

(b) Derivatives are relevant to the market risk and counterparty exposure limits. Consideration needs to be given both in the context of the exposure to the counterparty with whom the derivative contract is effected and to the impact on underlying counterparty exposures as a result of the acquisition or disposal of assets under the contract.92

(c) Liabilities arising under all derivative contracts, whether approved or not, will in the first place be determined in accordance with GAAP. However, where a derivative contract is not covered as prescribed in INSPRU 3.2, an additional provision will be needed to allow for reasonably foreseeable adverse variations. Normal liabilities will be included as “other creditors” at line 38 of Form 14 or line 49 of Form 15 and the

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92 INSPRU 2.1.9R requires the quantification of the amount of loss in determining counterparty or asset exposure to take into account synthetic exposures arising from derivatives or quasi-derivatives held or entered into by the insurer or any of its subsidiary undertakings.
provision for reasonably foreseeable adverse variations at line 41 of Form 14 or line 61 of Form 15.

(d) Assets and liabilities arising under non-linked derivative contracts (but not quasi-derivatives) together with notional amounts are analysed on Form 17, with the effect of variation margins being shown separately.

(e) A rule 9.29 statement has to be prepared, giving additional information on the use of derivative contracts and quasi-derivatives. This statement, unlike Form 17, covers linked as well as non-linked derivative contracts.

5.7. Although the IPRU(INS) guidance notes have been repealed, it may still be helpful to refer to the examples that were set out in Guidance Note 4.2 on the use of derivatives in insurance funds, when determining the treatment of derivatives and quasi-derivatives in the PRA return, though care should be taken in considering whether subsequent policy statements by the Regulator mean that the guidance must be regarded as superseded. The separate considerations relating to the use of derivatives in linked funds are indicated in section 2 of chapter 8.

5.8. Where a derivative contract is approved, any asset arising will be arrived at and reported on Form 13 under the investment rules. Variation margins (i.e. the amount of any cash or other net assets paid or transferred to the insurer in respect of the contract excluding initial margins) are deducted from the value so calculated, so that a net value will be shown on Form 13, although the gross value and the effect of margins are disclosed on Form 17.

5.9. There are a number of conditions that need to be satisfied if a derivative contract is to be capable of giving rise to an admissible asset. If any one of these is not satisfied, any asset is inadmissible. Although, in the context of non-linked assets, there is nothing to prevent an insurer from entering into an unapproved derivative contract and treating any asset arising under it as inadmissible, the circumstances surrounding the use of any derivative that does not meet the conditions will need to be explained as part of the rule 9.29 statement. In addition, even an unapproved derivative must be covered, if necessary by a provision, if it involves an obligation to deliver.

5.10. The INSPRU 3.2.5R conditions for a derivative to be approved are as follows:

(a) the contract is held for the purpose of efficient portfolio management or reduction in investment risk;

(b) the contract is covered; and

(c) the contract is effected or issued:

   (i) on or under the rules of a regulated market; or

   (ii) off-market with an approved counterparty and, except for a forward transaction, on approved terms and capable of being valued.

5.11. In respect of the final condition, a transaction is on approved terms only if the insurer reasonably believes that it could, in all reasonably foreseeable circumstances, and under normal market conditions, readily enter into a further transaction with the counterparty or a third party to close out the derivative at a price not less than the amount attributed to it by the firm, taking into account any valuation adjustments or reserves established by the insurer under GENPRU 1.3.29R to 1.3.34R (INSPRU 3.2.34R). A transaction is capable of valuation only if the insurer is able to value it with reasonable accuracy on a reliable basis in compliance with GENPRU 1.3.41R and reasonably believes that it will be able to do so throughout the life of the transaction.

5.12. Efficient portfolio management and reduction of investment risks represent alternative criteria, only one of which needs to be satisfied.
A contract will be regarded by INSINU 3.2.6R as held for the purpose of efficient portfolio management if the firm reasonably believes that it (either alone or together with any other covered transactions) enables the firm to achieve its investment objectives by:

► generating additional capital or income by taking advantage of pricing imperfections in relation (INSRU 3.2.7R) to the acquisition or disposal of rights in relation to assets the same as, or equivalent to, admissible assets, or receiving a premium for selling a covered call or its equivalent, even if the additional capital or income is obtained at the expense of surrendering the chance of greater capital or income;

► reducing tax or investment cost in relation to admissible assets; or

► acquiring or disposing of rights in relation to admissible assets, or their equivalent, more efficiently or effectively.

A contract would be regarded by INSRU 3.2.8R as held for the purpose of reducing investment risk if it (either alone or together with any other fully covered transactions) reduces any aspect of investment risk without significantly increasing any other element of that risk. It is not necessary that there be no possible adverse consequences. An increase in risk is deemed, by INSRU 3.2.9R to be significant unless either relative to any reduction in investment risk it is both small and reasonable or the risk is remote. This means that there is a proportionality test, and that some adverse consequences are acceptable. Investment risk is defined by INSRU 3.2.12R as the risk that admissible assets held to cover technical provisions might not be of a value at least equal to those provisions, or of appropriate safety, yield and marketability or of an appropriate currency.

5.13. INSRU 3.2.14R requires any obligation to transfer assets or pay monetary amounts arising not only from derivatives and quasi-derivatives but from any contract (other than a contract of insurance) for the purchase, sale or exchange of assets, to be covered. The requirement, as described in the repealed Guidance Note 4.2, that there should be no reasonably foreseeable possibility that the insurer will suffer a significant loss as the result of acquiring or realising investments in order to satisfy its obligations under the contract. There are various ways of achieving coverage:

(a) by holding the specific asset which has to be delivered (e.g. if a particular share has been sold forward) (this is referred to as strict coverage);

(b) by holding a reasonable approximation to the assets, where an obligation is based on an index or basket of assets;

(c) by the existence of an offsetting transaction; or,

(d) only in the case of an obligation to transfer money (including where an obligation to transfer an asset can be discharged by the transfer of money), by:

(i). holding admissible assets or where relevant permitted links of sufficient value that the cashflows arising from those assets will enable the money to be paid in the right currency when it falls due, after making allowance for any reasonable foreseeable adverse variations;

(ii). the existence of a liability that would decrease to offset any increase in the obligation; or
5.14. If the obligation is to transfer a specific asset and cannot be discharged by the transfer of any other asset or of money equivalent, only holding the asset itself or having an offsetting transaction will qualify.

5.15. In the absence (otherwise) of coverage, a provision for reasonably foreseeable adverse variations must be included on Form 14 or 15, to absorb any such variations that occur, and the methods and assumptions used to determine the amount explained in supplementary note 1401/1501. The obligation to establish a provision extends to non-approved derivatives. INSPRU 3.2.19G confirms that if a provision is established to meet a shortfall that would otherwise arise in the cover (because, for example, an obligation to transfer monetary assets could not be met in full), the derivative becomes covered and will qualify as approved if the other conditions are satisfied.

5.16. Quasi-derivatives (i.e. assets and contracts having the effect of derivatives) are treated in the same way as derivatives. This principle was developed after lengthy consultation with investors in the capital markets to capture instruments which, although they may not have the legal form of a derivative, nevertheless have the effect of operating in the same manner as a derivative. A wide range of items that would not normally be regarded as derivatives may be affected.

5.17. In view of the fact that paragraph (3) of GENPRU 2 Annex 7R has the effect that an asset which represents a quasi-derivative can only give rise to an admissible asset if it satisfies the conditions to be an “approved” quasi-derivative, it is important to try to achieve certainty as to whether any given asset does or does not represent a quasi-derivative. Some clarification was originally provided by the lists in Guidance Note 4.2 of types of asset that were or were not to be regarded as quasi-derivatives. These lists are no longer in force, and the FSA has since issued guidance at INSPRU 3.2.5AG which is principles-based. Unfortunately, the new principles-based guidance, while sacrificing some of the certainty of the old guidance, does not necessarily always provide insurers with the clarity that they may seek.

5.18. INSPRU 3.2.5AG(2) indicates that quasi-derivatives may be regarded as those contracts or assets which are not derivatives, but which contain an embedded derivative component which significantly impacts the contract’s or asset’s cash flow and risk profile so as to mirror the economic effect of a derivative. A holding in a fund investing in derivatives may or may not be a quasi-derivative depending on its ongoing investment policy and governance and any investment decisions from time to time which might deviate significantly from the investment policy. It should be treated as a quasi-derivative if its risk profile is such that the value of units in the fund is expected to mirror the value of a derivative.

5.19. The old Guidance Note 4.2 indicated that partly paid shares, agreements to underwrite or sub-underwrite share issues, bonds convertible to equity and instruments whose income (or maturity value) was set by reference to fluctuations in the value of some specified asset or by reference to fluctuations in an index, were all to be regarded as quasi-derivatives. INSPRU 3.2.5AG(5) provides a list of examples, but states that this is illustrative and not exhaustive, and indicates only that the assets cited all have features which could lead to their being assumed to be quasi-derivatives:

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

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93 A provision is implicitly set up to the extent that the obligation to pay the monetary amount is recognised under GENPRU 1.3 either by offset against an asset or as a separate liability. A provision is explicitly set up if it is in addition to an implicit provision. Any implicit provision must be reported in a supplementary note to Form 14 (code 1404) or 15 (1506) as appropriate.
(d) a credit-linked note, that is, a security with an embedded credit default swap.

5.20. INSINU 3.2 also, as mentioned above, deals with conditions for stock lending or repo transactions to count as approved and so for the assets lent to continue to represent admissible assets under GENPRU 2 Annex 7R. A stock lending transaction is defined in the glossary as the disposal of a designated investment subject to an obligation or right to reacquire the same or a similar designated investment from the same counterparty.

5.21. The key conditions prescribed by INSINU 3.2.36R for a transaction to count as approved are:

(a) the assets lent are admissible assets;

(b) the counterparty is an authorised person, an approved counterparty or one of a number of specified US counterparties; and

(c) except in the case of transactions made through the Euroclear Stock Lending Programme, adequate and sufficiently immediate collateral is obtained to secure the obligation of the counterparty.

5.22. The collateral conditions for this purpose are specified by INSINU 3.2.38R to 3.2.41R. In essence the collateral has to be of adequate quality (which may encompass the use of letters of credit), transferred to the firm, be at least equal in value at the time of the transfer to the value of the securities transferred and be kept topped up to the value of the securities. Collateral must be in place before close of business on the day of the transaction in order to be sufficiently immediate, but the Regulator has clarified that this can mean close of business in any time zone. Where the conditions are met, GAAP principles will be applied, which will mean that in completing Form 13, an insurer will report the asset lent at the line appropriate to the asset to which title has been transferred, and will not classify the arrangement as a debt. There are no specific rules in INSINU relating to situations where the insurer borrows securities (INSINU 3.2.37G).

5.23. Turning to disclosures in the return, there is a specific Form for the disclosure of information on derivative contracts, to which information may have to be appended by way of supplementary note on quasi-derivatives (but not stock lending arrangements). Form 17 provides an analysis of assets and liabilities arising under derivative contracts, other than contracts used for the purposes of calculating benefits payable under property-linked contracts or entered into to match liabilities in respect of the payment of index-linked benefits. Quasi-derivatives and stock lending transactions are not shown on this Form. Subject to the de minimis limits that apply, a separate Form 17 is required in respect of any Form 13 prepared for total long-term insurance business, total other than long-term insurance business and any long-term insurance business fund for which assets have been separately appropriated. An external direct insurer is not required to prepare Form 17 to correspond to the category 2, 3, 4, 6, 7 and 8 Forms 13. The total of the asset column will normally agree to line 44 of the corresponding Form 13, while the total of the liability column will represent the derivative element of the “other creditors” appearing at line 38 of Form 14 or line 49 of Form 15 as appropriate. The main analysis section of the Form (lines 11 to 35) breaks down derivatives into three basic types and subdivides each of the three types. The net effect of any variation margins paid, transferred or received in respect of contracts included at lines 11 to 35 (which are therefore gross of such margins) is shown at line 41. Form 17 does not include the provision for reasonably foreseeable adverse variations, which appears directly on Forms 14 (line 41) and 15 (line 61).

5.24. Form 17 requires an analysis of the value at the year end of derivative assets and liabilities, along with their notional amounts into three main categories: (1) futures and contracts for
differences, (2) in the money options\textsuperscript{94} and (3) out of the money options. Each of these is sub-divided. Futures and contracts for differences are broken down into:

(a) fixed-interest securities;
(b) interest rates;
(c) inflation;
(d) credit index/basket;
(e) credit single name;
(f) equity index;
(g) equity stock;
(h) land;
(i) currencies;
(j) mortality; and
(k) other.

The two options categories are subdivided into:

(a) swaptions;\textsuperscript{95}
(b) equity index calls;
(c) equity stock calls;
(d) equity index puts;
(e) equity stock puts; and
(f) other.

5.25. Columns 3 and 4, disclosing the notional amount as at the end of the year for contracts bought/long (column 3) and sold/short (column 4), must be completed in accordance with the Instructions to the Form. The notional amount is defined by Instruction 11 to the Form as follows:

(a) For interest rate and inflation swaps, the cash amount on which the swap is based.
(b) For credit default swaps, the nominal amount of the bonds on which the swap is based.
(c) For mortality swaps, the market value of the fixed future payments.
(d) For swaptions, the nominal amount on which conversion to a fixed interest rate will be applied.
(e) For options other than swaptions, the market value of the assets subject to the option.

\textsuperscript{94} An option is deemed to be in the money if it would be likely to be exercised based on market conditions as at the end of the financial year.

\textsuperscript{95} A swaption is defined in Chapter 11 of IPRU(INS) as an option granting its owner the right but not the obligation to enter into an underlying swap.
(f) For futures, the market value of the asset that is contracted to be bought or sold.

(g) For other contracts for differences, the nominal value of the property, index or other value referenced by the contract.

5.26. Instruction 12 provides five principles for determining whether a contract falls to be reported in column 3 or column 4. A contract is bought/long (and conversely sold/short) if it is:

(a) For currency futures and contracts for differences, a contract where the insurer pays sterling. A currency contract not involving sterling must be replicated as a contract into sterling and a contract out of sterling (one likely being long, the other short).

(b) For interest rate and inflation swaps, a contract where the insurer receives a fixed rate in exchange for paying a variable (short term deposit) rate. A swap between a short term deposit rate and inflation must be replicated as a deposit/fixed and a fixed/inflation swap.

(c) For credit default swaps, a contract where the insurer receives a fixed payment in exchange for taking on credit risk.

(d) For mortality swaps, a contract where the insurer receives a fixed payment in exchange for taking on mortality risk.

(e) For options, a contract where the insurer has the option to buy the underlying or has provided the option to a counterparty to sell the underlying.

5.27. The Regulator considers that presenting the notional amounts defined in the way indicated provides useful indicators for it and other users of the extent of activity, protection or exposure to complement the values indicated in the Form and acts as a basis for requesting further information. If only the net notional amount were reported, this could mask the true level of exposure to derivative counterparties.

5.28. A de minimis limit applies where the year end total notional amount (i.e. the sum at line 51 of bought/long in column 3 and sold/short in column 4) exceeds the lesser of £100m and assets not held to match linked liabilities (Form 13.89.1 minus the sum of Form 13.58.1 and Form 13.59.1). That comparison determines whether a category 1 or category 10 Form 17 is required: if a category 10 Form 17 is prepared, a Form 17 is also required for each fund or group of funds reported separately on Form 17, however small the use of derivatives may be.

5.29. Instructions 7 and 10 to the Form make it clear that it is only variation margin that can appear in line 41; rights to recover assets transferred by way of initial margin will go directly to the appropriate line on Form 13. Where for any derivative contract included in Form 17, assets have been transferred to or for the benefit of the insurer by way of variation margin, a supplementary note to Form 17 (code 1701) is required to state:

(a) the aggregate amount of any liability to repay such assets or equivalent assets

(b) for each line in Form 13, the amount included in respect of such assets

(c) to what extent any amounts included in Form 13 have taken account of any requirement to repay such assets or equivalent assets.

5.30. If the aggregate value of rights under quasi-derivatives exceeds 2½% of total admissible assets per Form 13 line 89, or the aggregate amount of liabilities under quasi-derivatives exceeds 2½% of the aggregate of the amounts shown in lines 17 to 39 of Form 14 or lines 31 to 51 of Form 15, as appropriate, the corresponding value must be stated by way of a supplementary note to Form 17 (code 1702) for each line in Form 13, 14 or 15.

5.31. Form 17 shows the situation at a particular point in time, and is supplemented by a rule 9.29 statement giving additional information on derivatives and quasi-derivatives. The statement
should go into sufficient detail to provide a concise meaningful summary of the use of derivatives. The requirement applies to both linked and non-linked funds. The prescribed disclosures are as follows:

(a) Any investment guidelines operated by the insurer for the use of derivative contracts. The insurer’s policy needs to be explained, even if its policy is not to use derivatives.

(b) Any provision made by such guidelines for the use of contracts under which the insurer had a right or obligation to acquire or dispose of assets which was not, at the time when the contract was entered into, reasonably likely to be exercised and, if so, the circumstances in which, pursuant to that provision, such contracts would be used.

(c) The extent to which the insurer was during the financial year a party to any contracts of the kind described in (b). A brief description of the size (in economic exposure) of the contracts and the approximate market movement that would trigger them is required in these circumstances.

(d) The circumstances surrounding the use of any derivative or quasi-derivative held at any time during the financial year that required a significant provision to be made for it under INSPRU 3.2.17R or the equivalent conditions to be a permitted derivative contract in relation to linked business.

(e) The total value of any fixed consideration received by the insurer (whether in cash or otherwise) during the financial year in return for granting rights under derivatives and quasi-derivatives and a summary of contracts under which such rights have been granted.
Chapter 5 – Liabilities

The rules for determining liabilities are somewhat less prescriptive than those for assets considered in the previous chapter. Different considerations apply to long-term insurance business and other than long-term insurance (including general insurance) business, with separate Forms (14 and 15) being prescribed for the two; these are discussed in sections 1 and 2 respectively. The disclosures relating to contingent liabilities are, however, common to all business, and in view of the detail of the supplementary note requirements in this area, a separate section 3 has been included to deal with these. Section 4 deals with the specific area of general insurance business discounting for which there are prescribed disclosures on Form 30, although the extent to which discounting is beneficial for solvency purposes is severely restricted.

1. **Determination of long-term insurance business liabilities (Form 14)**

1.1. Form 14 deals with long-term insurance business margins as well as liabilities. The margins are relevant since INSPOU and IPRU(INS) restrict the use of long-term insurance business assets, and INSPOU 1.5.27R forbids the transfer of surplus assets identified by an actuarial valuation more than 3 months after the valuation date. Such assets therefore remain ring-fenced for long-term insurance business purposes until there is a further actuarial valuation. The Form in effect covers four types of item:

- (a) mathematical reserves – provisions made by an insurer to cover liabilities (excluding liabilities which have fallen due and liabilities arising from deposit-back arrangements) arising under or in connection with long-term insurance business liabilities;

- (b) accounting liabilities, including long-term insurance business liabilities that have fallen due and liabilities arising from deposit back arrangements;

- (c) the provision for reasonably foreseeable adverse variations; and

- (d) margins.

1.2. The return preserves the concept of fund accounting for long-term business. The long-term insurance business fund represents the excess of the long-term insurance business assets over non-technical accounting liabilities and the provision for reasonably foreseeable adverse variations, together with any amounts taken to an investment reserve outside the fund. The purpose of the actuarial valuation is to determine mathematical reserves at a given date. These can then be compared with the fund and any surplus or deficiency arising identified. Rule 9.10 requires the amount of liabilities reported in the return to be determined in accordance with GENPRU 1.3. The “GAAP” presumption of GENPRU 1.3.4R explained in the previous chapter is overridden by specific provisions in INSPOU 1.2 in respect of the methods and assumptions that a firm must use to determine its mathematical reserves. The mathematical reserves are determined net of reinsurance, overriding the gross presentation requirements of FRS 5 and IFRS 4.

1.3. The key specific principles contained in INSPOU 1.2 can be summarised as follows:

- INSPOU 1.2.22R requires in principle that the mathematical reserves are determined separately for each contract, with the subsequent rules defining the prospective valuation basis to be applied. It permits appropriate approximations or generalisations to be made where they are likely to provide the same or a higher result than individual calculations on a contract by contract basis, and requires additional mathematical reserves to be established on an aggregated basis for general risks that are not specific to individual contracts. Approximations or generalisations can also be made, in the case of non-attributable expenses arising from non-profit business, in relation to a group of contracts with the same or similar
characteristics, provided that the mathematical reserves in respect of such expenses established by the firm in relation to those contracts have a minimum value of at least zero.

► INSPRU 1.2.24R requires that no contract with a guaranteed surrender value may be treated as an asset. However, any other contract may be treated as an asset provided that this is based on prudent assumptions, and that the total mathematical reserves are not negative. Where the non-guaranteed long-term insurance contracts include any linked contracts, the mathematical reserves must have a value at least as great as the sum of the insurer’s property-linked liabilities and index-linked liabilities.  

► INSPRU 1.2.26R requires the mathematical reserves to be sufficient for any contract of insurance to ensure that at any future time the mathematical reserves then required are covered solely by the assets representing the current mathematical reserves, the resources arising from those assets and the contract itself.  

► INSPRU 1.2.28R requires the cash flows to be valued in a prospective valuation to include future premiums, expenses including commissions, benefits payable and amounts to be received or paid in respect of the long-term insurance contracts under contracts of reinsurance or analogous non-reinsurance financing agreements. Benefits payable for this purpose, as prescribed by INSPRU 1.2.29R, include:

1. all guaranteed benefits, including guaranteed surrender values and paid-up values
2. vested, declared and allotted bonuses to which the policyholder is entitled
3. all options available to the policyholder under the terms of the contract
4. discretionary bonuses payable in accordance with the firm’s duty to treat customers fairly.

► INSPRU 1.2.33R requires the rates of interest used to be determined in accordance with INSPRU 3.1.28R to 3.1.47R. The INSPRU 3.1 requirements include a margin to allow for adverse deviation in market risk and, where relevant, credit risk.

► INSPRU 1.2.38R requires a regulatory basis life firm, in valuing its with-profits insurance contracts (except for accumulating with-profits policies written on a recurrent single premium basis) to attribute a value to a future premium which does not exceed the lower of the actual premium payable under the contract and the net premium (which may be increased for deferred acquisition costs in accordance with INSPRU 1.2.43R). “Net premium” is defined by the Handbook glossary as the premium that is calculated to provide the basic sum assured under a with-profits insurance contract, taking into account only the mortality and interest rate risks and using the same assumptions as used in the calculation as the mathematical reserves. This approach retains the difference between the gross premium and the net premium as an implicit margin available to finance future bonuses, expenses and other costs.

Guidance at INSPRU 1.2.25G indicates that firms should consider whether negative mathematical reserves are suitable for offset against liabilities on other contracts. Whilst INSPRU 1.2.24R applies at a firm level, the Regulator states that liabilities in a with-profits fund may not be offset, for purposes of compliance with the specific requirement to maintain admissible assets in a with-profits fund (INSPRU 1.1.27R), against negative mathematical reserves in other funds of the insurer.  

For the purpose of this rule a firm must assume that the assumptions adopted for the current valuation of liabilities remain unaltered and are met, and that discretionary benefits and charges will be set so as to fulfil its regulatory duty to treat its customers fairly.  

The distinction between a realistic basis life firm and a regulatory basis life firm is discussed in paragraph 6.3 of chapter 8.
INSPRU 1.2.46R allows a realistic basis life firm to use a gross premium basis for valuing future premiums for its with-profits insurance contracts (except for accumulating with-profits policies written on a recurrent single premium basis).

INSPRU 1.2.48R requires a firm not to attribute any value to future premiums payable under accumulating with-profits policies written on a recurrent single premium basis. Any liability arising only upon payment of the premium may also be ignored, except to the extent that the value of that liability upon payment would exceed the amount of that premium.

INSPRU 1.2.50R requires provision to be made, either implicitly or explicitly, for expenses of an amount which is not less than the amount which is expected, on prudent assumptions, to be incurred in fulfilling its long-term insurance contracts.

INSPRU 1.2.55R requires the provision for expenses to be sufficient to cover all the expenses of running off the firm’s existing long-term insurance contracts.

INSPRU 1.2.59R requires the firm to set the assumptions for mortality and morbidity using prudent rates that are appropriate to the country or territory of residence of the person whose life or health is insured. The rates should contain prudent provision for adverse deviation.

INSPRU 1.2.62R requires a firm to include in the mathematical reserves an amount to cover any increase in liabilities which might be the direct result of its policyholder exercising an option under, or by virtue of, that contract of insurance. Where the surrender value of a contract is guaranteed, the amount of the mathematical reserves for that contract must be at least as great as the value guaranteed at that time.

INSPRU 1.2.76R allows firms to make assumptions about voluntary discontinuance rates in the calculation of the mathematical reserves, provided that those assumptions meet the general requirements for prudent assumptions as set out in INSPRU 1.2.10R and INSPRU 1.2.13R.

INSPRU 1.2.77AR identifies that the analogous non-reinsurance arrangements that are to be treated in the same way as reinsurance for the purposes of the subsequent rules include contingent loans, securitisations and any other arrangements in respect of contracts of insurance that are analogous to contracts of reinsurance in terms of the risks transferred and the finance provided.

INSPRU 1.2.79R requires reinsurance cash flows to be valued using methods and assumptions which are at least as prudent as the methods and assumptions used to value the underlying contracts of insurance that have been reinsured. However, INSPRU 1.2.79R(2) permits reinsurance cash flows that are unambiguously linked to the emergence as surplus of margins included in the valuation of existing contracts of insurance or to the exercise by a reinsurer of its rights under a termination clause not to be valued.

INSPRU 1.2.79AR sets out two further conditions to be satisfied if reinsurance cash flows are not to be valued under INSPRU 1.2.79R. Firstly, the reinsurance must not be connected with any other transaction which, taken together with it, could result in the INSPRU 1.2.79R(2) conditions no longer being satisfied, or in the risk transferred under the reinsurance being undermined. Secondly, the present value of the reinsurance cash flows to be disregarded must not at any time exceed the value of the aggregate net cashflows received, accumulated at an assumed rate of LIBOR + 6%. Under INSPRU TP 7, contracts which were in place and accepted before 10 December 2009 (the date of an FSA letter to the ABI expressing its concerns about the acceptability of cashless transactions) are grandfathered without need to comply with these additional provisions.
INSPRU 1.2.85R provides that the “link” for the purposes of INSPRU 1.2.79R must be such that a contingent liability to pay or repay the amount to the reinsurer could not arise except, and to the extent that, the margins in the valuation of the existing contracts of insurance emerge as surplus or the reinsurer exercises its rights under a termination clause in the contract as a result of specified factors, (fraudulent conduct by the firm in relation to the contract, non-payment of reinsurance premiums, etc.).

INSPRU 1.2.86R allows future surplus to be offset against future reinsurance cash outflows only in respect of surplus on non-profit insurance contracts and the charges or shareholder transfers arising as surplus from with-profits insurance contracts.

The mathematical reserves are summarised on Forms 50 to 54 which will be considered further in chapter 8. Calculation of the reserves is carried out by the holder of the actuarial function, in accordance with the methods and assumptions determined by the insurer’s governing body. The actuary will have regard to professional guidance notes issued by the Faculty and Institute of Actuaries in carrying out the valuation.

Where surplus has arisen, an insurer may deal with it in a number of ways. Distribution of surplus is dealt with on Form 58, which is again considered in chapter 8. However, for the present it is important to identify the effect on the Appendix 9.1 Forms of the various types of distribution:

Reversionary bonuses, other bonuses and premium reductions all have the effect of increasing the actuarial liabilities. Mathematical reserves included at line 11 of Form 14 are therefore required to be stated after the distribution of surplus by these means (the prescribed source is Form 58 lines 21, 43, 44 and 45).

Cash bonuses give rise to a liability to pay money to policyholders, but will not be charged to the fund until actually paid out. The liability is separately disclosed at line 12 of Form 14.

Bonus payments made to policyholders in anticipation of a surplus will, by definition, have been paid out before the year end and therefore do not need to be included on Form 14.

Transfers to shareholders’ funds are shown as a movement on the revenue account and deemed to have taken place as at the year end. It is not appropriate to establish a liability on Form 14 and an asset on the shareholders’ Form 13 since, legally speaking, there cannot be a debt owed by an insurer to itself that could qualify as an admissible asset. The proper approach would be to treat part of the policyholders’ assets as belonging to the shareholders at the year end. For example, if payment is in fact to be made from one bank account to another, the relevant part of the first bank balance would be included on the shareholders’ Form 13.

Any surplus not distributed will be included at line 13 of Form 14.

The sum of lines 11 to 13 is reported at line 14 and will correspond to the fund carried forward on Form 40 at line 59.

It is necessary, in addition to a total Form 14, for a separate Form to be prepared for each separate long-term insurance business fund or group of funds for which separate assets have been appropriated, and for each with-profits fund that would not otherwise need to be reported. These additional Forms correspond to the category 11, 12, etc. Form 13s, although there is no longer a computer heading to Form 14 to refer to these category numbers. In the case of a with-profits fund for which separate assets have not been appropriated, a supplementary note (code 1406) must be included to state the amount, if any, of the increase or decrease in the value of non-linked assets. Where the amount (or part of the amount) of any increase or decrease in the value of non-linked assets has yet to be allocated between the with-profits funds, the note must state the total amount which has yet to be allocated.
identifying the with-profits funds to which the information relates and describing the bases on which increases in the value of non-linked assets are or will be allocated.

1.6. Accounting liabilities on the Form will be determined in accordance with the GAAP principle of GENPRU 1.3.4R (unless one of the exceptions applies) and will correspond to the accounts figures in the absence of an adjusting post balance sheet event after the accounts have been signed off. The analysis of the accounting liabilities is reasonably self-explanatory and closely follows the Schedule 3 balance sheet format. Gross outstanding claims which had fallen due for payment before the end of the financial year, and which therefore do not form part of mathematical reserves, are reported separately at line 15, with any related reinsurance recoveries being shown as a deduction at line 16.

1.7. It can be a matter of considerable importance whether a particular liability falls to be dealt with under the actuarial or accounting rules, as these can give rise to very different results. The INSPRU rules described in paragraph 1.3 above demonstrate where liabilities for reinsurance and analogous financing arrangements whose crystallisation is contingent on the emergence of future profits may, provided they meet conditions, be derecognised.

1.8. Line 41 deals with the provision for reasonably foreseeable adverse variations, which may need to be established in addition to the actuarial and accounting liabilities. This was referred to in paragraph 5.15 of chapter 4 in the context of derivative contracts. While the provision is most likely to arise in the context of a derivative, INSPRU 3.2.14R is worded more widely and applies to any obligation to transfer assets or pay a monetary amount arising from a non-derivative contract (other than a contract of insurance) for the purchase, sale or exchange of assets. A supplementary note (code 1401) is required to specify the methods and assumptions used to determine the amount of any provision for reasonably foreseeable adverse variations or, if there is no provision, the methods and assumptions used to determine that no provision is required.

1.9. Line 51 is described as “excess of the value of net admissible assets” and cannot legitimately be negative. This will only normally contain a figure if an insurer maintains an investment reserve to which investment gains are taken in the first instance and elects to take advantage of rule 9.10 of IPRU(INS) which allows assets to be taken at book, rather than Form 13, value for the purposes of the actuarial investigation. Where this is the case, any asset that is not admissible must not be taken into account, and the aggregate value of assets taken into account must not exceed the aggregate Form 13 value; if the aggregate value is lower the fund carried forward will be less than the admissible value of assets, and a balancing figure is consequently included to eliminate this difference.

1.10. Line 61 is a memorandum figure of liabilities to related companies, other than those under contracts of insurance or reinsurance, while line 62 states the total liability in respect of property-linked benefits. The repealed Guidance Note 9.1 indicated that line 62 should report liabilities relating to property-linked benefits of the type that would fall to be included under liability items C and D of the Schedule 3 balance sheet, but determined under the PRA Handbook rules.

1.11. Lines 72 to 76 present a reconciliation to accounts liabilities. This reconciliation is considered, alongside the corresponding reconciliation on Form 15, in paragraph 2.19 below. In the context of Form 14, it should be noted that the reconciliation only has to be completed on the total Form, and that these lines should be left blank on any sub-fund Forms.
2. Determination of other than long-term insurance business liabilities (Form 15)

2.1. Form 15 is required to be completed by every insurer except an insurer not trading for profit which carries on only long-term insurance business,\(^99\) and analyses other than long-term insurance business liabilities under three main headings:

(a) general insurance business technical provisions

(b) other GAAP liabilities

(c) other items required by GENPRU or INSPRU to be treated as liabilities.

2.2. Items falling under (a) and (b) will be included on a GAAP basis under GENPRU 1.3.4R, save for adjustments to reverse the impact of discounting other than that permitted by Instruction 4 to this Form, to reflect an election to record a pension fund deficit at the deficit reduction amount, or to adjust certain changes in the value of liabilities held at fair value through profit and loss. The specific rules relating to equalisation provisions are considered in section 7 of chapter 6, while the provision for reasonably foreseeable adverse variations to be established in relation to derivatives was considered in paragraph 1.8 above: supplementary note 1501, which is equivalent to supplementary note 1401 to Form 14, is required.

2.3. Lines 11 to 19 deal with gross technical provisions. The technical provision headings on Form 15 closely follow liability item C per the Schedule 3 balance sheet. However, Schedule 3 allows options for the disclosure of the reinsurers’ share of technical provisions. These may either be included under assets item D, or shown as negative items under liabilities item C; as indicated at paragraph 1.8 of chapter 4 the former treatment is mandatory for the return (and is anyway likely to be that adopted for the accounts). Schedule 3 also grants an option to show deferred acquisition costs as a deduction from unearned premiums rather than as an asset under balance sheet heading G II; again, this option is not available in completing the return for general insurance (whereas for long-term insurance, it is the presentation implied by the design of the Form).

2.4. The design of Form 15 is, as with the Schedule 3 balance sheet, predicated upon annual accounting, the objective of which is to arrive at an underwriting result for the financial year by matching premiums earned in the year against claims incurred in the year.\(^100\) A number of specific provisions need to be recognised to enable this matching to be achieved. These provisions are as follows:

(a) unearned premiums (line 11)

(b) claims outstanding (line 12)

(c) unexpired risks (line 13).

2.5. The unearned premium provision (line 11) corresponds to balance sheet liability heading C1 and is defined by Schedule 3 as “the amount representing that part of gross premiums written which is estimated to be earned in the following financial year or subsequent financial years”. Many of the policies written by an insurer will cover a term which does not precisely coincide with the insurer’s financial year, and it is therefore necessary to apportion the premiums over the years in question to determine how much is regarded as earned in each. The carry forward is derived from Form 21 line 19 column 2 and the gross element of Form 25 line 22 column 99-99. Paragraph 50 of Schedule 3 requires in principle that the provision

\(^99\) Although some pure life mutuals which have issued subordinated debt have in practice completed the Form purely in order to report the subordinated debt liability at line 63.

\(^100\) As will be seen in the next chapter, the format of the returns would accommodate a different basis of accounting whereby the recognition of profits is deferred, however neither the ABI SORP nor IFRS recognises this as a valid basis of accounting and consequently it is unlikely to be encountered other than in a historical context.
be calculated separately for each insurance contract, but does allow statistical methods (and in particular proportional and flat rate methods) to be used where they may be expected to give approximately the same results as individual calculations. Given modern capabilities of insurance companies for data handling, the use of proportional or flat rate methods may need more justification than in the past. The 24ths method, which breaks down premiums by month of inception and assumes that on average policies incept in the middle of the month, might meet the test of giving approximately the same result, but that less accurate methods may well not do. Supplementary notes to the underlying revenue accounting Forms (codes 2102 and 2501) are required to state the basis on which unearned premiums are calculated and the reason for adopting this basis. The “reason” stated must include an explanation of any change in the basis from previous financial years.

2.6. The provision for claims outstanding (line 12) corresponds to Schedule 3 balance sheet liability heading C2, but after removing the benefit of discounting in most cases, and is defined by that Schedule as comprising the total estimated ultimate cost to the insurer of settling all claims arising from events which have occurred up to the end of the financial year (including, in the case of general insurance business, claims incurred but not reported) less amounts already paid in respect of such claims. The Form 15 entry is derived from Form 22 column 3 for business accounted for on an accident year basis - line 11 plus 14 plus 15 plus 18 - and from Form 25 column 99-99 for business accounted for on an underwriting year basis - line 11 plus line 13 plus line 15 plus line 20. Discounting adjustments can still be made in respect of class 1 or 2 business, annuities or in the case of a pure reinsurer which went into run-off before the implementation of the Reinsurance Directive and does not have permission under FSMA to effect contracts of insurance. Where one of these situations applies (or where the insurer has a relevant waiver), the appropriate element of the discounting adjustments at Form 22 lines 31 and 33 and Form 25 lines 16 and 18 will need to be taken into account in arriving at Form 15 line 12.

2.7. The general principles laid down by paragraph 53 of Schedule 3 for determining claim provisions are as follows:

1. A provision shall in principle be computed separately for each claim on the basis of the costs still expected to arise, save that statistical methods may be used if they result in an adequate provision having regard to the nature of the risks.

2. The provision shall also allow for claims incurred but not reported by the balance sheet date, the amount of the allowance being determined having regard to past experience as to the number and magnitude of claims reported after previous balance sheet dates.

3. All claims settlement costs (whether direct or indirect) shall be included in the calculation of the provision. In respect of indirect costs, there are supplementary note disclosures in relation to Forms 22 and 24, which are considered in chapter 6.

4. Implicit discounting or deductions, whether resulting from the placing of a current value on a provision for an outstanding claim which is expected to be settled later at a higher figure or otherwise effected, cannot be used. However, explicit discounting, or deductions to take account of investment income is permitted for the purposes of Schedule 3 (the regulatory rules are far more restrictive), subject to certain conditions being satisfied. The topic of discounting is considered further in section 4 of this chapter.

2.8. GENPRU 1.3.57R lays down specific requirements for the establishment of outstanding claims provisions relating to Community co-insurance operations. These requirements stem from the EU Co-insurance Directive, which represented an early step towards the single EU insurance markets by permitting co-insurers to participate in risks located elsewhere in Europe without a local authorisation where there was a leading insurance undertaking with the leading insurance undertaking is defined by Chapter 11 as an insurance undertaking which is recognised as the leading insurance undertaking by the other insurance undertakings involved in the operation and which determines the terms and conditions of insurance for the operation.
the necessary authorisation. A relevant co-insurance operation is defined by the Directive, as modified by Article 26 of the second Non-Life Directive as a direct insurance acceptance in any general insurance business class other than 1, 2, 17 or 18 (and excluding class 13 risks which concern damage arising from nuclear sources or from medicinal products), which meets all the following conditions:

(a) The risk is covered by a single contract at an overall premium and for the same period by two or more insurance undertakings, each for its own part;

(b) The risk is situated\(^{102}\) within an EEA State; and

(c) At least one of the insurance undertakings participating in the operation does so through a head office or branch established in an EEA State other than that in which the leading insurance undertaking’s head office (or if the leading insurance undertaking is participating through a branch, that branch) is established.

2.9. If an insurer participating in a Community co-insurance operation has been informed by the leading insurer of the amount of the provision which that insurer has made in respect of the operation, the provision that it makes must be at least as great as the leading insurer’s provision, having regard to the respective proportions of the risk covered. Where it is not the practice in the United Kingdom to make such a provision separately, the overall provision for outstanding claims must be sufficient, when all liabilities are taken into account, to include provision at least as great as that made by the leading insurer for such claims.

2.10. The provision for unexpired risks (line 13) is defined by Schedule 3 as “the amount set aside by an insurer at the end of its financial year, in addition to any unearned premiums, which is considered necessary to meet the cost of claims and expenses of settlement arising from risks to be borne by the insurer after the end of the financial year under contracts of insurance entered into before the end of that year”. Such a provision may be required because the unearned premiums provision represents a simple time apportionment of premiums, normally based on the assumption that there is an equal likelihood of a claim arising at any date within the policy term, and is not necessarily sufficient by itself to meet the claims which do arise, or in the light of information available at the year end are seen as likely to arise, during the unexpired policy term. If the claims and related expenses are expected to exceed the provision for unearned premiums (together with any further premiums receivable), then it is appropriate to establish an unexpired risk provision of such an amount as is considered necessary to boost the provision for unearned premiums to the level that will avoid an underwriting loss arising on the policies in question in the next financial year. This is derived from the sum of Form 22.19.3 and 25.23.99-99. Although there is space at Form 13 line 62 for disclosure of the reinsurers’ share of the unexpired risks provision, relatively few insurers are in practice likely to include figures at that line. The question of offsetting surpluses and deficits between categories in setting the unexpired risk provision is considered in chapter 6 paragraph 3.14, together with the disclosures necessary where the expected investment return is taken into account.

2.11. Lines 14 and 15 deal with claims equalisation provisions required by law, which are discussed in section 7 of chapter 6. Any remaining technical provisions not falling within the definitions given above will appear at line 16; in practice it would be unusual to have an entry at this line (and the corresponding Form 13 line 63 for the reinsurers’ share). For underwriting year business, there is a source for any such provision at Form 25 line 25 (with a requirement for particulars to be specified by way of a supplementary note code 2505); for accident year business, transfers to or from any such provision would need to be included at line 16 or 25 of Form 20 as other technical income or charges (again with a supplementary note - code 2005).

\(^{102}\) A risk is deemed to be situated within an EEA State in the case of insurance relating to immovable property, if the property is situated in an EEA State, in the case of insurance relating to a registered vessel, aircraft or vehicle (including railway rolling stock), if the vessel, aircraft or vehicle is registered in an EEA State and in any other case, if the policyholder is incorporated or has his habitual residence in an EEA State.
2.12. The insurance liabilities at lines 31 and 41 to 43 correspond to lines 23 and 31 to 33 on Form 14. Several of the other liabilities headings again correspond to Form 14, but three are peculiar to Form 15. Commentary is provided in the next paragraph in respect of the line relating to cumulative preference share capital (line 62): subordinated loan capital (line 63) has a similar regulatory status but does represent a GAAP liability. Line 48 reflects GENPRU 2.2.87R which requires dividends to be deducted for regulatory capital purposes as soon as they are foreseeable. GENPRU 2.2.87AG indicates that each firm must assess for itself when, in its particular circumstances, dividends are foreseeable. A dividend is foreseeable at the latest when, in the case of an interim dividend, it is declared by the directors and, in the case of a final dividend, when the directors approve the dividend to be proposed at the annual general meeting. It is likely that such entries will not represent GAAP liabilities and will therefore constitute reconciling items in the lower section of the Form (and a valuation difference on Form 3).

2.13. The treatment of cumulative preference share capital is somewhat anomalous in the context of the approach of GENPRU. The return shows such shares as a liability on Form 15 notwithstanding that they may for GAAP purposes have the status of equity. The Form 15 treatment differs from the treatment of such shares under GENPRU. They represent, provided that the conditions of GENPRU 2.2 are satisfied, and subject to the operation of the gearing rules, tier two capital. There is therefore no obvious reason why such shares should have to be treated as a liability on Form 15: the main effect of so doing is to introduce an entry on the Form 3 reconciliation of capital resources to net admissible assets, and an entry on the Form 15 reconciliation. Any accrued dividend in respect of cumulative preference shares is required to be disclosed in supplementary note 1503. The equivalent treatment of subordinated debt capital is less anomalous, as this represents a GAAP liability.

2.14. Generally accepted accounting practice, UK or IFRS as applicable, is of direct relevance to the determination of liabilities on Form 15 in view of GENPRU 1.3.4R. It is normal practice for an insurer’s return to include, as a deferred tax provision on Form 15, the figure arrived at for accounts purposes under FRS 19 or IAS 12, and it is arguable that this is what GENPRU 1.3.4R requires, although there would be theoretical merit and under some circumstances prudence would strongly suggest adjusting the provision in the return to reflect the additional tax that would be payable if assets were realised or liabilities settled at the amounts on which they are shown at Forms 13 to 15 (and it is common practice for long-term insurers to adjust deferred tax balances to reflect technical provisions calculated according to INSPRU 1.2). There is a requirement to disclose by way of supplementary note (code 1502) the total potential liability to taxation on capital gains as well as the amount actually provided.

2.15. Accounting for pension costs raises issues for any insurer that has a defined benefit pension scheme. The actuarial gains and losses that can be recorded for such schemes under IFRS and UK GAAP can be large and volatile, and experience suggests that many companies will have large liabilities to report. The Regulator has considered that it is inappropriate to treat such amounts as if they were current liabilities for regulatory purposes, and GENPRU 1.3.9R(2) to 1.3.11G therefore permits replacement of the accounting liability, at the option of the firm, with the “deficit reduction amount”. This term represents the firm’s best estimate, in conjunction with the scheme’s actuaries or trustees, of the amount of funding, net of tax, that will require to be paid into the scheme over the following five year period for the purpose of reducing the firm’s defined benefit liability. Any election to use the deficit reduction amount must be applied consistently for the purposes of GENPRU in respect of any one financial year. A firm is required to keep a record of and be ready to explain to its supervisory contacts in the PRA the reasons for any difference between the deficit reduction amount and any commitment that the firm has made in any public document to provide funding in respect of a defined benefit occupational pension scheme. In PS05/5 the FSA indicated that the deficit reduction amount should be calculated on an undiscounted basis.

2.16. A further departure from the GAAP presumption is provided at GENPRU 1.3.9R(1). Where a firm designates liabilities on original recognition as at fair value through profit and loss, it must adjust for any unrealised gains or losses on subsequent revaluation, that are not

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103 This is perhaps counter-intuitive given that tax is not netted off other liabilities (including the pension provision if the insurer opts to recognise its accounting liability).
attributable to changes in a benchmark interest rate. A firm does not, in other words, reflect changes in its own credit risk in the revaluation of such liabilities.

2.17. Line 71 gives a memorandum figure of non-insurance liabilities to related companies (which will include dividends due to a parent undertaking).

2.18. Lines 81 to 85 of the Form (lines 71 to 76 of Form 14) present a reconciliation to the accounts liabilities and shareholders’ funds. As conceptually these (together with the analogous reconciliation on Form 13) perform a similar reconciliation to Form 3, care will be needed to ensure that the reconciling items are classified consistently as between Form 3 and these Forms.

2.19. The reconciliations themselves are straightforward once it has been appreciated that these are to liabilities including shareholders’ funds (which appear on the liabilities side of a Schedule 3 balance sheet) per the accounts. The reconciliation is only required if the insurer prepares accounts under Schedule 3 or IFRS for the purpose of its external financial reporting: otherwise the lines are left blank.

2.20. There are three types of reconciling item to be presented.

(a) Those specifically prescribed. For Form 14 these are adjustments in respect of DAC-related liabilities (line 72), which must be adjusted for any associated deferred tax, and the reinsurers’ share of technical provisions (line 73), which are appropriate given the way that long-term technical provisions are presented (i.e. net of reinsurance), which flows through also to the treatment of DAC for long-term insurance. The Form 15 line 82 adjustment for amounts deducted from technical provisions for discounting is also prescribed (see paragraph 4.3 below).

(b) Other adjustments to liabilities (Form 14 line 74 and Form 15 line 83). This is the sweep up line (which may be negative), and any entry will need to be explained in a supplementary note (code 1405 or 1507). Any difference between the Companies Act gross technical provisions and the gross mathematical reserves will feature at this line.

(c) Capital and reserves and (in the case of Form 14) the fund for future appropriations (Form 14 line 74 and Form 15 line 84). A composite will need to split the Companies Act capital and reserves between the two Forms in line with the allocation of the capital resources towards the general and long-term capital resources requirements.

3. **Contingent liabilities**

3.1. The Accounts and Statements Rules require extensive disclosure of contingent liabilities and similar commitments. GAAP considerations will determine the extent to which actual provision needs to be made for such an item on Form 14 or 15. However, the PRA requires also disclosure of liabilities with a contingent aspect, including where a liability has been recognised but the amount at which it is recognised depends on contingency.

3.2. The required supplementary note (code 1402 or 1502) stems from paragraph 13 of Appendix 9.1 and has five elements:

(a) Details of charges over assets (see paragraph 3.4 below) or a statement that there are no such charges. There is a de minimis limit in respect of charges attributable to either long-term insurance or general insurance business assets and whose aggregate value as shown on Form 13 does not exceed 2.5% of the long-term insurance assets (excluding reinsurance recoveries and assets required to match property-linked liabilities) or other assets (excluding reinsurance recoveries).

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104 As with the analogous reconciliation on Form 13, some external insurers have adopted the practice in their global returns of reconciling to liabilities and equity under their home state GAAP, which appears sensible if not strictly compliant.
(b) The total potential liability to tax on capital gains (calculated on the basis of a hypothetical disposal of all assets immediately after the year end and including liability to tax on capital gains) and the amount actually provided or a statement that there is no contingent liability. The repealed Guidance Note 9.1 indicated that liability to foreign taxes on capital gains should be included.

(c) A brief description of any other contingent liability not included in Form 14 or 15 (other than liabilities arising under an inward contract of insurance or reinsurance - liabilities under outward contracts of reinsurance are disclosable) including, where practicable, the amounts or estimated amounts of those liabilities, or a statement that there are no such contingent liabilities. The repealed Guidance Note 9.1 indicated that there was no need to disclose remote contingent liabilities.

(d) A brief description of any guarantee, indemnity or other contractual commitment in respect of the existing or future liabilities of any related company, or a statement that there are no such guarantees, indemnities or contractual commitments.

(e) A description of any other uncertainty where such a description is in the opinion of the directors, necessary for a proper understanding of the financial position of the insurer. Unlike sub-paragraph (c) there is no exemption from uncertainties arising from inward contracts of insurance or reinsurance. Significant uncertainties in respect of exposure to losses from latent diseases or environmental pollution, as well as litigated matters such as the World Trade Center loss of 2001, have therefore in the past resulted in disclosures under this sub-paragraph.

3.3. Given the wording of paragraph 13 of Appendix 9.1, negative statements are necessary in respect of the first four elements if there are no disclosable items, so this supplementary note will always need to be present.

3.4. A “charge” is defined as including any arrangement whatsoever, whether contractual or otherwise, which operates to secure the prior claim of any person over general creditors to any assets on a winding up of the insurer. As examples of the types of item that fall within this broad definition, the repealed Guidance Note 9.1 cited:

(a) arrangements whereby assets of the insurer are placed in trust for the prior benefit of only some creditors;
(b) assets held as collateral by creditors or by issuers of letters of credit;
(c) fixed and floating charges; and
(d) equivalent arrangements under the laws of overseas countries.

3.5. Where a charge as defined in the foregoing paragraph does exist, the three items required by paragraph 13(2) of Appendix 9.1 to be disclosed are:

(a) the nature of the charge, including a brief description of the terms which are relevant to securing the prior claim of any person to assets which are subject to the charge;
(b) for each line in Form 13, the amount included in respect of assets which are subject to the charge; and
(c) for each line in Form 14 or 15, the amount included in respect of liabilities which are secured by the charge (it is possible for there to be no such amounts included where a charge has served only to secure the prior claim of a contingent or potential creditor).

3.6. Although each charge should strictly be disclosed separately, the repealed Guidance Note 9.1 indicated that it was possible, in the interests of clarity or brevity, to disclose in aggregate
charges which arose from the same related series of transactions or charges which were of
the same nature and had substantially the same relevant terms.

3.7. Guarantees, indemnities and other contractual commitments in respect of the existing and
future liabilities of any related companies are disclosable unless either they are effected in
the ordinary course of the insurer’s insurance business (the repealed Guidance Note 9.1 cited the example of a motor insurer insuring the car fleet of a related company using the same underwriting principles as for its other fleet business), or a de minimis level of 2.5% of the long-term insurance or general insurance business amount is not exceeded by the aggregate of the maximum liabilities specified. Where an item is disclosable, the “brief description” must include:

(a) the maximum liability of the insurer specified in the guarantee, indemnity or contractual commitment or, where no such amount is specified, a statement to that effect;

(b) the amount of any provision made in respect of such liability; and

(c) the amount reported under the contingent liabilities disclosure in respect of such liability.

4. Discounting (Form 30)

4.1. The practice of discounting all or part of general insurance outstanding claims provisions as a feature of insurance accounting in a number of countries can be regarded as consistent with a general tendency in accounting towards fair value measurement. The EU Insurance Accounts Directive is less tolerant, permitting discounting at the option of a member State (an option exercised in the UK in drawing up the insurance accounts rules), but only subject to the following conditions, which in view of GENPRU 1.3.4R apply equally to discounting within the return:

(a) The expected average interval between the date for the settlement of claims being discounted and the accounting date shall be at least four years.

(b) The discounting or deductions shall be effected on a recognised prudential basis.

(c) When calculating the total cost of claims, the insurer shall take account of all factors that could cause increases in that cost.

(d) The insurer shall have adequate data at its disposal to construct a reliable model of the rate of claims settlements.

(e) The rate of interest used for the calculation of present values shall not exceed a rate prudently estimated to be earned by assets of the insurer which are appropriate in magnitude and nature to cover the provisions for claims being discounted during the period necessary for the payment of such claims, and shall not exceed either:

(i). a rate justified by the performance of such assets over the preceding five years or

(ii). a rate justified by the performance of such assets during the year preceding the balance sheet date.

105 A related company is defined by Chapter 11 in relation to an insurer as a subsidiary undertaking of the insurer, a company of which the insurer is a subsidiary undertaking, or a subsidiary undertaking of a company of which the insurer is a subsidiary undertaking. This is not the same as the glossary definition of ‘related undertaking’ that is used in, among other things, the valuation rules, and care should be taken in applying the correct definition in the circumstances where each is required.

106 The position under IFRS is less clear-cut than under UK GAAP, since measurement is not dealt with under IFRS 4. Whilst that standard includes a presumption against the adoption of discounting, that does not preclude continuation of discounting where that was already a feature of national GAAP.
Chapter 5 – Liabilities

4.2. However, for solvency purposes the difference between the discounted and undiscounted technical provisions must be added back, except for business in classes 1 and 2 and for any annuities included in technical provisions. An increasing tendency for periodic payment orders in some liability classes involving personal injury may bring more claims within the scope of this exemption. GENPRU 2.2.107R(3) also exempts a pure reinsurer which became a firm in run-off before 31 December 2006 and whose Part 4A permission has not subsequently been varied to add back the regulated activity of effecting contracts of insurance.

4.3. If an insurer’s liabilities meet the criteria for discounting it has a free choice as to whether it does or does not discount for regulatory purposes. The position of an insurer which discounts in its accounts is as follows for accounts purposes:

► Forms 31 to 34 continue to report figures on an undiscounted basis.

► Form 16 and the 20 series of Forms will reflect the discounting adjustments made in the accounts. However, many of the 20 series Forms isolate the effect of discounting to specific lines and columns. The specific disclosures in required by Appendix 9.2 will be discussed further in chapter 6.

► The claims provision at Form 15 line 12 and the reinsurers’ share thereof at Form 13 line 61 will be on an undiscounted basis unless one of the exceptions applies, with the difference between the discounted and undiscounted figures being reported in the reconciliations at Form 15 line 82 and Form 13 line 100.

► A deduction from tier one capital resources to eliminate the benefit from discounting will, unless one of the exceptions applies, be made at line 34 of Form 3.

► Forms 11 and 12 will be prepared on an undiscounted basis.

4.4. Form 30, comprising two sheets, provides information about the expected income and yield from admissible assets covering discounted provisions, so as to demonstrate that the particular interest rates that the insurer has used in the discounting calculations are justified, though in view of the requirement to reverse the discounting adjustment, it may be queried whether the Form serves any useful purpose. Sheet 1 must be completed by any insurer that is discounting, showing separately each major currency (defined as a currency for which the undiscounted claims provision is not less than 10% of the total) with other currencies being dealt with in aggregate at line 21. Sheet 2 is only required if the undiscounted provision for the claims outstanding being discounted exceeds 25% of the total undiscounted provision. If an insurer does not have to prepare sheet 2 it can treat 25% rather than 10% as being the threshold for major currencies for the purposes of sheet 1 and can omit the other currencies and total lines.

4.5. The key comparison on Form 30 is between the actual rate of interest at which the provision for outstanding claims is being discounted (highest, lowest and average rates are required to be shown in columns 9 to 11), and the yield in column 4 generated by the related assets. While an insurer is required to state, in column 1 of the Form, the assets (for the currency on sheet 1 or the category on sheet 2) derived from Form 13, it has a free choice as to whether to indicate in column 2 a value for admissible assets hypothecated to cover the provision for claims being discounted or repeat the column 1 figures. The yield is then calculated by reference to the column 2 figures: for securities with a redemption value this will be the gross redemption yield, for other assets the running yield. On balance it appears desirable for any insurer discounting to hypothecate specific assets. The provision for outstanding claims being discounted (columns 6 and 7) and the total technical provisions (column 5) are required to be completed net of reinsurance (the repealed Guidance Note 9.1 clarified that column 5 will exclude equalisation provisions and columns 6 and 7 will include any provisions for claims management costs which are being discounted). To be consistent with...
this, the Form 13 figures used exclude the reinsurers’ share of technical provisions and deferred acquisition costs.

4.6. The following information is required by way of supplementary note to Form 30:

(a) the methods and assumptions used in determining the yield (code 3001);

(b) the treatment of expected income payments from any asset where such payment is in default (code 3002); and

(c) the risk categories where adjustments for discounting have been made, and in respect of each such risk category:

(i). the methods used in calculating the deduction for discounting;

(ii). the rate of interest used for the calculation of present values;

(iii). the expected average interval between the date for settlement of claims being discounted and the end of the financial year; and

(iv). the criteria adopted for estimating the period that will elapse before claims are settled (code 3003).

4.7. Where the reinsurers’ share of claims incurred (as stated in Form 22 or 25) includes amounts expected to be recovered from reinsurers more than twelve months after the payment of the underlying gross claims by the insurer, a supplementary note (code 2206 or 2503) to those Forms is required by paragraph 28 of Appendix 9.2, stating:

(a) the amount of such recoveries; and

(b) the accounting treatment which has been adopted in respect of discounting such recoveries.
Rule 9.3 sets out the basic requirement that an insurer should prepare and submit to the PRA a profit and loss account. In section 1 of this chapter there will be a discussion of the Forms prescribed (16 and 20) for this purpose in respect of general insurance business as a whole. The total business is sub-divided further, and section 2 of this chapter introduces the concept of reporting categories, reviews the currency requirements and addresses the completion of the Form 20A on which the key figures (presented without applying the \textit{de minimis} limits) are summarised. Sections 3 and 4 then look at the more detailed Forms that apply primarily at the combined category level depending upon whether an accident year or underwriting year basis of accounting is adopted, and sections 5 and 6 at the secondary subdivisions at the risk category level for, respectively, direct and facultative business and treaty reinsurance business. Section 7 concludes the chapter by explaining the rules relating to equalisation provisions.

1. **Introduction (Forms 16 and 20)**

1.1. The insurance accounts rules as reflected in Schedule 3 adopt the Insurance Accounts Directive requirement of prescribing an overall profit and loss account format which is divided into a “technical account” (required separately for general insurance business and long-term insurance business) and a “non-technical account”. Forms 16 and 20 mirror this split and are respectively entitled “Profit and loss account (non-technical account)” and “General business: technical account (excluding equalisation provisions)”.

1.2. The division between the technical account and non-technical account for a general insurer is not necessarily as clear as this distinction would suggest as there can be difficulties of definition in deciding what is a technical item and what is not. The allocation of the following items is clear-cut:

<table>
<thead>
<tr>
<th>Technical account</th>
<th>Non-technical account</th>
</tr>
</thead>
<tbody>
<tr>
<td>Premiums</td>
<td>Taxation</td>
</tr>
<tr>
<td>Claims</td>
<td>Dividends</td>
</tr>
<tr>
<td>Claims handling expenses</td>
<td></td>
</tr>
<tr>
<td>Acquisition costs</td>
<td></td>
</tr>
</tbody>
</table>

1.3. However, insurers do have certain options for other items of income and expenditure. The treatment of investment items can differ between insurers, though the initial treatment is prescribed. With the exception of amounts relating to long-term insurance business policyholders’ funds which are considered in chapter 8, it is necessary to include items relating to the investment function in the first instance on Form 16 and in full, utilising the following lines:

<table>
<thead>
<tr>
<th>Investment income</th>
<th>line 14</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment income</td>
<td></td>
</tr>
<tr>
<td>value re-adjustments on</td>
<td>line 15</td>
</tr>
<tr>
<td>investments</td>
<td></td>
</tr>
<tr>
<td>gains on the realisation of</td>
<td>line 16</td>
</tr>
<tr>
<td>investments</td>
<td></td>
</tr>
<tr>
<td>Investment charges</td>
<td>line 17</td>
</tr>
<tr>
<td>investment management charges</td>
<td></td>
</tr>
<tr>
<td>value re-adjustments on</td>
<td>line 18</td>
</tr>
<tr>
<td>investments</td>
<td></td>
</tr>
</tbody>
</table>
1.4. An insurer then has the option to transfer all or part of the allocated investment return to the general insurance business technical account by making entries at line 20 of Form 16 and line 51 of Form 20. The following comments can be made about these treatments.

► The option to transfer an element of the allocated investment return from the non-technical account to the technical account is derived from Schedule 3 and is available as part of the general thrust of enabling the return to mirror the accounts. Where this option is exercised, it will be necessary to break down the transferred investment return between reporting categories.

► Under the ABI SORP, an insurer that chooses to make a transfer can do so either on the basis of the actual investment return on investments supporting the general insurance business technical provisions and associated shareholders’ funds, or on the basis of the longer term rate of return. Whichever approach is adopted in the accounts should also be applied in the return.

► Schedule 3 also contains an option to enable investment income and charges to be directly attributed to the technical account. The ABI SORP does not advocate this option (it is problematic in that there is no corresponding option to attribute unrealised gains and losses directly to the technical account) and its exclusion from the return is logical.

► The disclosures at lines 14 to 19 of Form 16 correspond to format headings 3 and 5 in the Schedule 3 non-technical account, although with a slightly lesser degree of subdivision. In particular, the separate format headings 3a and 5a for unrealised gains and losses on investments do not appear as such on the Form, and unrealised gains and losses will consequently need to be included at lines 15 and 18 as “value re-adjustments”.

► Schedule 3 allows an insurer either to take its unrealised gains and losses to a revaluation reserve or to allocate them in whole or in part to the non-technical account. The ABI SORP indicates that unrealised gains and losses should be taken to the non-technical account, except for movements in the value of interests in group companies, associates and joint ventures (unless the interests form part of an investment portfolio) which should be taken to revaluation reserve. Instruction 1a to Form 16 indicates that regardless of the treatment adopted in the accounts, unrealised gains and losses should be reflected on Form 16 by inclusion at lines 15 and 18. An insurer which includes certain investments at amortised cost in its Schedule 3 accounts and therefore records a valuation difference at Form 13 line 98 (as line 102 reflects the amortised cost) should include on Form 16 the unrealised gains or losses relative to that amortised cost, not to market value.

► For an insurer preparing its accounts under IFRS, the preparation of the return may pose problems in respect of items that are dealt with not in the profit and loss account but through other comprehensive income, particularly in this context movements in the fair value of financial instruments that are classified as available for sale. Logic might suggest that these and other items of other comprehensive income, not being allowed to pass through profit and loss, should be recorded with appropriate narrative in supplementary note 0313. However, the rules do not deal with this matter and some insurers have chosen to include these items on Form 16.

1.5. There is relatively little flexibility under the Accounts and Statements Rules over the treatment of expenses, as the heading “administrative expenses” appears on Forms 22 and 24 but not on Form 16. Administrative expenses are defined by Schedule 3 as follows:
“This item shall include the costs arising from premium collection, portfolio administration, handling of bonuses and rebates, and inward and outward reinsurance. They shall in particular include staff costs and depreciation provisions in respect of office furniture and equipment in so far as these need not be shown under acquisition costs, claims incurred or investment charges.”

1.6. Comparatively few routine outgoings will fall outside this definition. Although there remains a sweep up line 21 on Form 16 for other income and charges, relatively few items can be legitimately included at this line: anything within the administrative expenses definition will have to be taken to Appendix 9.2 and broken down by reporting category. If there is an entry at Form 16 line 21, particulars will need to be provided in a supplementary note (code 1603).

1.7. Form 16 otherwise calls for little comment. The transfer from the general insurance business technical account excluding movements on equalisation provisions (line 11), and the transfer from the long-term insurance business technical account (line 13), are derived from Form 20.59 and Form 40.26 respectively. As will be seen in chapter 8, the latter remains based on the “statutory” method of accounting and is therefore likely to differ from the figure in the accounts. Any extraordinary profit or loss (a concept now rarely employed in UK GAAP and not recognised in IFRS) included at line 41 will need to be explained in a supplementary note (code 1604). In a branch return the bottom line of the Form is taken to Form 10 line 62 as an element of the reconciliation of the balance of available assets. In a global return the bottom line is taken to supplementary note 0313 (see chapter 3 paragraph 2.23).

1.8. Form 20 is prepared both in respect of general insurance business as a whole and for the prescribed subdivisions. In the former case ‘001’ is entered in the category box; in the latter the number of the category concerned. The 001 Form is simply the sum of the underlying Form 20s, which will be considered in detail in the following sections. In general terms, lines 11 to 29 deal with accident year accounting and lines 31 to 39 bring in the balance for underwriting year accounting. The balance of all years’ underwriting (line 49) is then adjusted by the allocated investment return to arrive at the transfer to or from Form 16 (line 59). This figure will often differ from the bottom line of the technical account in the Schedule 3 accounts, because it excludes the transfer to or from the equalisation provisions that will be considered in section 7 below; such transfers are included directly on Form 16 at line 12.

1.9. The Accounts and Statements Rules allow business to be recorded on either of two bases, being “accident year accounting” and “underwriting year accounting”, for which separate revenue Forms are prepared and certain figures are shown separately on Forms 11, 12 and 15. The essential difference between the two terms relates to the basis on which claims statistics are maintained, by reference either to the date on which a claim occurs (accident year basis) or to the date of inception of the contract of insurance which gave rise to the claim (underwriting year basis).

1.10. Where general insurance business is written in foreign currencies, then depending upon the accounting policy adopted, technical provisions brought forward per the revenue account are likely to differ from technical provisions carried forward per the previous return. In these circumstances, Instruction 1 to Form 16 indicates that it would be appropriate to include a supplementary note (code 1602) where any brought forward amounts on any Form are restated due to currency retranslation. A simple statement along the lines of “Some of the brought forward amounts shown in the Forms [xx to xx] have been restated from the corresponding carried forward amounts included in the previous year’s return due to the reconversion of foreign currency amounts at a different rate of exchange” is sufficient, with no further details being necessary. Paragraph 8A of Appendix 9.2 requires a supplementary note if there are other factors contributing to a difference. Depending upon the number of Forms affected, there may be a whole series of supplementary notes generated (codes 2101, 2201, 2301, 2401, 2601, 2701, 2801, 3101, 3201 and 3401 could all potentially be triggered). Form 20 does not include brought forward figures, but there is a prescribed supplementary note 2011 (analogous with 0111, etc. in Appendix 9.1) to explain any differences in the comparatives.
2. Reporting categories and currencies (Forms 20A and 36)

2.1. Although a limited amount of segmental information is provided in the notes to the accounts, considerably more detail is required for the purposes of the regulatory return. This is partly to enable the mixture of business written by a particular insurer to be understood and for risks of an analogous nature to be grouped together so that meaningful comparisons can be made with its peer group. However, perhaps more significant is the provision of detailed claims development statistics so that the adequacy of the claims provisions can be independently assessed. The detailed requirements address how the following critical issues are to be dealt with:

(a) Identification of reporting categories;
(b) Setting of *de minimis* provisions, to avoid the need for immaterial subdivisions to be reported;
(c) Provision of information gross or net of outward reinsurance, on specific Forms;
(d) The number of years' loss development to be reported on each Form; and
(e) The approach to be taken to business transacted in currencies other than sterling.

2.2. These issues are addressed as follows:

(a) The reporting categories are defined in the rules at two levels of analysis which will be referred to in this booklet as the primary subdivisions – a relatively high level breakdown corresponding largely to the combined categories, and the secondary subdivisions – a more detailed breakdown into risk and miscellaneous categories. The primary subdivisions are reported on Forms 20 to 25, whereas the secondary subdivisions are reported on Form 26 onwards. The prescription of reporting categories improves the comparability of returns between insurers, although the prescribed categories may not always reflect the subdivisions that an insurer uses to manage the business and for internal reporting and reserving purposes.

(b) *De minimis* provisions (or materiality thresholds) operate at the level of both the primary and the secondary subdivisions. As there are no reconciliation Forms for the secondary subdivisions, it is not necessarily possible to prove mathematically within the return the consistency of the secondary subdivisions with the primary subdivisions. Form 20A sets out the overall profile of the business ignoring the *de minimis* rules.

(c) For direct and facultative business, only gross information is presented at the secondary subdivision level. The secondary treaty subdivisions and the primary subdivisions present both gross and reinsurance information.

(d) Ten years of origin are generally required to be reported, although the secondary subdivisions for treaty business and direct and facultative liability business need to be reported to extinction. It is permissible for underwriting and accident years ending prior to 31 December 1976 to be reported in aggregate.

(e) The emphasis of the rules is very much on currency rather than country, and the secondary subdivisions are required to be reported in the underlying currency, although a limited “reporting territory” concept is also used on Forms 31, 32 and 34.

2.3. The categories are defined in Annex 11.3 of IPRU(INS). This itemises a grand total of 78 categories, although as will be seen some of these (the combined categories) simply represent aggregations of a number of underlying risk categories. The full list of categories,

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107 For treaty business, later cut-off dates are specified in the Instructions to each Form, reflecting the timing of the introduction of particular Forms.
and their categorisation (the significance of which is explained in the ensuing paragraphs), is as follows:

<table>
<thead>
<tr>
<th>Code</th>
<th>Description</th>
<th>Risk/Exemption</th>
</tr>
</thead>
<tbody>
<tr>
<td>001</td>
<td>Total business (001 + 002)</td>
<td>Combined*</td>
</tr>
<tr>
<td>002</td>
<td>Total primary (direct) and facultative business (110 + 120 + 160 + 180 + 220 + 260 + 270 + 280 + 330 + 340 + 350 + 400)</td>
<td>Combined*</td>
</tr>
<tr>
<td>003</td>
<td>Total treaty reinsurance accepted business (700 + 800 + 900)</td>
<td>Combined*</td>
</tr>
<tr>
<td>110</td>
<td>Total primary (direct) and facultative accident and health business</td>
<td>Combined</td>
</tr>
<tr>
<td>111</td>
<td>Medical expenses</td>
<td>Risk</td>
</tr>
<tr>
<td>112</td>
<td>HealthCare cash plans</td>
<td>Risk</td>
</tr>
<tr>
<td>113</td>
<td>Travel</td>
<td>Risk</td>
</tr>
<tr>
<td>114</td>
<td>Personal accident or sickness</td>
<td>Risk</td>
</tr>
<tr>
<td>114(p)</td>
<td>Personal accident as a result of insured travelling as a passenger</td>
<td>Exemption</td>
</tr>
<tr>
<td>120</td>
<td>Total primary (direct) and facultative personal motor business (121 to 123)</td>
<td>Combined</td>
</tr>
<tr>
<td>121</td>
<td>Private motor comprehensive</td>
<td>Risk</td>
</tr>
<tr>
<td>122</td>
<td>Private motor non-comprehensive</td>
<td>Risk</td>
</tr>
<tr>
<td>123</td>
<td>Motor cycle</td>
<td>Risk</td>
</tr>
<tr>
<td>160</td>
<td>Total primary (direct) and facultative household and domestic all risks</td>
<td>Risk*</td>
</tr>
<tr>
<td>180</td>
<td>Total primary (direct) and facultative personal lines financial loss business (181 to 187)</td>
<td>Combined</td>
</tr>
<tr>
<td>181</td>
<td>Assistance</td>
<td>Risk</td>
</tr>
<tr>
<td>182</td>
<td>Creditor</td>
<td>Risk</td>
</tr>
<tr>
<td>183</td>
<td>Extended warranty</td>
<td>Risk</td>
</tr>
<tr>
<td>184</td>
<td>Legal expenses</td>
<td>Risk</td>
</tr>
<tr>
<td>185</td>
<td>Mortgage indemnity</td>
<td>Risk</td>
</tr>
<tr>
<td>186</td>
<td>Pet insurance</td>
<td>Risk</td>
</tr>
<tr>
<td>187</td>
<td>Other personal financial loss</td>
<td>Risk</td>
</tr>
<tr>
<td>220</td>
<td>Total primary (direct) and facultative commercial motor business (221 to 223)</td>
<td>Combined</td>
</tr>
<tr>
<td>221</td>
<td>Fleets</td>
<td>Risk</td>
</tr>
<tr>
<td>222</td>
<td>Commercial vehicles (non-fleet)</td>
<td>Risk</td>
</tr>
<tr>
<td>223</td>
<td>Motor other</td>
<td>Risk</td>
</tr>
<tr>
<td>260</td>
<td>Total primary (direct) and facultative commercial lines property business (261 to 263)</td>
<td>Combined</td>
</tr>
<tr>
<td>261</td>
<td>Commercial property (including livestock and crops but excluding energy)</td>
<td>Risk</td>
</tr>
<tr>
<td>262</td>
<td>Consequential loss (i.e. business interruption)</td>
<td>Risk</td>
</tr>
<tr>
<td>263</td>
<td>Contractors or engineering all risks</td>
<td>Risk</td>
</tr>
<tr>
<td>270</td>
<td>Total primary (direct) and facultative commercial lines liability business (271 to 274)</td>
<td>Combined</td>
</tr>
<tr>
<td>Code</td>
<td>Description</td>
<td>Category</td>
</tr>
<tr>
<td>------</td>
<td>-----------------------------------------------------------------------------------------------------------</td>
<td>----------</td>
</tr>
<tr>
<td>271</td>
<td>Employers’ liability (including the employers’ liability part of mixed liability packages but excluding mixed commercial packages)</td>
<td>Risk</td>
</tr>
<tr>
<td>272</td>
<td>Professional indemnity (including directors’ and officers’ liability and errors and omissions insurance)</td>
<td>Risk</td>
</tr>
<tr>
<td>273</td>
<td>Public and products liability</td>
<td>Risk</td>
</tr>
<tr>
<td>274</td>
<td>Mixed commercial package</td>
<td>Risk</td>
</tr>
<tr>
<td>280</td>
<td>Total primary (direct) and facultative commercial lines financial loss business (281 to 284)</td>
<td>Combined</td>
</tr>
<tr>
<td>281</td>
<td>Fidelity and contract guarantee</td>
<td>Risk</td>
</tr>
<tr>
<td>282</td>
<td>Credit</td>
<td>Risk</td>
</tr>
<tr>
<td>283</td>
<td>Suretyship</td>
<td>Risk</td>
</tr>
<tr>
<td>284</td>
<td>Commercial contingency</td>
<td>Risk</td>
</tr>
<tr>
<td>330</td>
<td>Total primary (direct) and facultative aviation business (331 to 333)</td>
<td>Combined</td>
</tr>
<tr>
<td>331</td>
<td>Aviation liability (including liability part of airline packages)</td>
<td>Risk</td>
</tr>
<tr>
<td>332</td>
<td>Aviation hull (including hull part of airline packages)</td>
<td>Risk</td>
</tr>
<tr>
<td>333</td>
<td>Space and satellite</td>
<td>Risk</td>
</tr>
<tr>
<td>340</td>
<td>Total primary (direct) and facultative marine business (341 to 347)</td>
<td>Combined</td>
</tr>
<tr>
<td>341</td>
<td>Marine liability</td>
<td>Risk</td>
</tr>
<tr>
<td>342</td>
<td>Marine hull</td>
<td>Risk</td>
</tr>
<tr>
<td>343</td>
<td>Energy (on and off-shore)</td>
<td>Risk</td>
</tr>
<tr>
<td>344</td>
<td>Protection and indemnity</td>
<td>Risk</td>
</tr>
<tr>
<td>345</td>
<td>Freight demurrage and defence</td>
<td>Risk</td>
</tr>
<tr>
<td>346</td>
<td>War risks</td>
<td>Risk</td>
</tr>
<tr>
<td>347</td>
<td>Yacht</td>
<td>Risk</td>
</tr>
<tr>
<td>350</td>
<td>Total primary (direct) and facultative goods in transit</td>
<td>Risk*</td>
</tr>
<tr>
<td>400</td>
<td>Miscellaneous primary (direct) and facultative business</td>
<td>Miscellaneous</td>
</tr>
<tr>
<td>409</td>
<td>Balance of all primary (direct) and facultative business</td>
<td>Balancing</td>
</tr>
<tr>
<td>500</td>
<td>Total non-proportional reinsurance treaty business accepted (510 to 590)</td>
<td>Combined</td>
</tr>
<tr>
<td>510</td>
<td>Non-proportional accident &amp; health</td>
<td>Risk</td>
</tr>
<tr>
<td>520</td>
<td>Non-proportional motor</td>
<td>Risk</td>
</tr>
<tr>
<td>530</td>
<td>Non-proportional aviation</td>
<td>Risk</td>
</tr>
<tr>
<td>540</td>
<td>Non-proportional marine</td>
<td>Risk</td>
</tr>
<tr>
<td>550</td>
<td>Non-proportional transport</td>
<td>Risk</td>
</tr>
<tr>
<td>560</td>
<td>Non-proportional property</td>
<td>Risk</td>
</tr>
<tr>
<td>570</td>
<td>Non-proportional liability (excluding motor)</td>
<td>Risk</td>
</tr>
<tr>
<td>580</td>
<td>Non-proportional financial lines</td>
<td>Risk</td>
</tr>
<tr>
<td>590</td>
<td>Non-proportional aggregate cover (i.e. more than one of the above)</td>
<td>Risk</td>
</tr>
<tr>
<td>600</td>
<td>Total proportional reinsurance treaty business accepted (610 to 690)</td>
<td>Combined</td>
</tr>
</tbody>
</table>
Annex 11.3 contains detailed definitions for each category and links the risk categories to specific authorisation classes (the eighteen classes of business specified in Part I of Schedule 1 to the Regulated Activities Order).

2.4. The majority of the categories itemised in the previous paragraph are categorised as either risk or combined. Risk categories represent the basic units, and are reported as the secondary subdivisions, where the de minimis limits are exceeded, on Forms 26 to 29 for treaty reinsurance and Forms 31, 32 and 34 for direct and facultative business. The combined categories represent a combination of underlying risk categories and are reported as the primary subdivisions, where the de minimis limits are exceeded, on Forms 20 to 25. There are a number of exceptions to this simple two level classification.

► Combined categories 001, 002 and 003 (which were highlighted as “combined*” in the previous paragraph) are referred to in this booklet as “super-combined categories”. These are a combination of other combined categories, and are distinguished by the fact that the de minimis limits do not apply. Consequently Forms 20 to 25 will always need to be prepared for each of these categories if there is any business in the category in question regardless of its quantum. Thus an insurer which only wrote direct business would not have to prepare 003, but would need to report both 001 and 002 (which in this case would contain the same figures).

► For direct and facultative business, risk categories 160 (household and domestic all risks) and 350 (goods in transit), which have been highlighted as “risk*” in paragraph 2.3 also have to be reported on Forms 20 to 25, if the de minimis limits are exceeded, as if these were also combined categories.

► The Regulators recognise that some risks may not fall within any of the defined risk categories and have therefore prescribed 400 and 700 as miscellaneous categories (which are still technically risk categories) for direct and facultative business and treaty reinsurance business respectively. The use of these categories is likely to be comparatively rare, and any business reported therein will need to be identified in supplementary note 20Ac. In the same way as categories 160 and 350, the miscellaneous categories have to be reported, subject to the de minimis limits, both on the risk category Forms and on the combined category Forms.

► The balancing categories relate to business that does not have to be reported on Forms 20 to 25 for a combined category, miscellaneous category or category 160 or

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The term has no basis in the Accounts & Statements Rules but is adopted for convenience to distinguish these categories from other combined categories in view of the different rules applicable to them.
Chapter 6 – Revenue accounting – general insurance business

350 because of the *de minimis* limits. This is purely a reporting approach in relation to these Forms: every risk will fall into a risk category and will need to be reported by reference to this true underlying category on Form 20A (to which *de minimis* limits do not apply).

Categories 114(p) and 710(p) are referred to as exemption categories, although this may be regarded as a little misleading as these are not reported as standalone categories on any of the Forms. In effect these represent a device to allow insurers flexibility to report general business class 1(p) risks (accident risks relating to a person insured sustaining injury, or dying, as the result of travelling as a passenger) in either the accident class or the class relating to the means of transport in question. Such risks would for direct and facultative business normally be reported in risk category 114 (personal accident or sickness), but if an insurer elects to treat these as falling into exemption category 114(p), then notwithstanding that these fall within the definition of 114, these can be reported in any of risk categories 121 to 123, 221 to 223, 331 to 333 or 341 to 347. Similarly, for treaty reinsurance business, risks treated as falling into 710(p) can be reported within risk categories 520, 530, 540, 590, 620, 630, 640 and 690 notwithstanding that these also fall within the definition of 510 or 610. A supplementary note (code 20Ab) is required to indicate the risk categories to which any contracts of insurance against risks of death of, or injury to, passengers have been allocated.

2.5. The Regulators also recognise that a given policy issued by an insurer may contain elements that fall into more than one risk category. Categories 274 (mixed commercial package), 590 (non-proportional aggregate cover) and 690 (proportional aggregate cover), which are discussed in detail in later sections, have been introduced to deal with certain policies of this nature. If a contract falls within the definition of risk category 274, 590 or 690, it is mandatory under rule 9.14B(2) to allocate that contract to that category. In the case of any other contract falling within the description of more than one risk category, the normal treatment under rule 9.14B(3) will be to allocate all the business represented by the contract to the single risk category which, in the opinion of the insurer’s governing body, best describes the risk covered by the contract. However, this approach (but not the requirement to allocated to category 274, 590 or 690 where applicable) can be overridden by rule 9.14B(4) and a reasonable allocation of the business made between the relevant risk categories and reported on the Forms if the premium is separable into the components relating to different risk categories, or in the reasonable opinion of the insurer’s governing body, allocation under rule 9.14B(3) would be misleading. Where any allocation has been made under rule 9.14B to a risk category, other than to 274, 590 or 690, the following information must be disclosed in a supplementary note (code 20Aa):

(a) the name of the risk category
(b) a description of the general insurance business allocated to the relevant risk category
(c) the rationale for the allocation decision made
(d) the amounts included in Form 20A under the risk category in respect of general insurance business allocated to the risk category under rule 9.14B
(e) in the case of an allocation made under rule 9.14B(4), a description of the method used to make that allocation.

2.6. The *de minimis* limits referred to apply not only to risk categories but to combined categories other than the super-combined categories 001, 002 and 003. The basic limits are the same for both the primary and the secondary subdivisions, although as will be seen there are additional considerations relevant to the risk categories as materiality there is judged not by reference to a risk category as a whole but by reference to a risk category for a particular currency and (in the case of direct and facultative business) for a particular reporting territory, and the 80% principle of rule 9.20A (see paragraph 2.13) can lead to risk categories...
otherwise below the *de minimis* limits having to be reported in order to ensure adequate coverage of the book of business as a whole. The basic limits are expressed in paragraph 2B of Appendix 9.2 and are twofold, requiring a category to be reported if any one of the following three tests is met:

(a) the insurer’s gross undiscounted provisions in the category of business at the end of the financial year exceed:
   (i) £100 million; or
   (ii) the higher of 5% of the insurer’s total gross undiscounted provisions and £1 million;

(b) the insurer’s gross written premiums in the category of business in the financial year exceed:
   (i) £100 million; or
   (ii) the higher of 5% of the insurer’s total gross written premiums and £1 million;

(c) the category was required to be reported in the return for the previous financial year (subject to the provisions described in paragraph 2.8 below).

2.7. “Gross written premiums” is self-evident and corresponds to the figures that feed into Form 11 line 11: any difference between total gross premiums per Form 20A.1.1 and Form 11.11.1 would need to be explained in a supplementary note (code 20Al). “Gross undiscounted provisions” is defined by rule 9.20(5) as gross undiscounted reported claims outstanding plus gross undiscounted incurred but not reported claims plus gross provision for unearned premiums plus provision for unexpired risks (implicitly, also gross). This therefore excludes claims management costs and equalisation provisions.

2.8. The categories that are material can, of course, vary from year to year, and it may not be evident until the claims provisions have been finalised as to whether particular categories are reportable. If a category that was not material in the previous year becomes material, it needs to be reported going forward with its full back history. Categories ceasing to be material are somewhat more complex, as the rules seek to differentiate between a category which has temporarily dipped below the limit and a category for which there has been a permanent fall in its significance. There are two circumstances in which rule 9.20 permits a category required to be reported in the previous return to be omitted.

(a) If, in respect of a category reported for at least three financial years, both the gross premiums written for a financial year and the gross undiscounted provisions at the end of that financial year are less than half of the reporting criteria, the category can be omitted for that financial year

(b) If however both the gross premiums written for a financial year and the gross undiscounted provisions at the end of that financial year are less than £0.5 million (i.e. half of the normal absolute floor), the category may be omitted for that financial year, even if the percentage share of gross premiums or gross undiscounted provisions remains above the 2½% that (a) would indicate.

2.9. The use of the words “required to be reported” in the *de minimis* limits implies that a category reported in the 2012 return and previous returns despite being below the *de minimis* limits could be dropped in the 2013 return if it remained below the limit. The inclusion of a supplementary note in these circumstances (or indeed if (a) or (b) is applicable) is strongly recommended.

2.10. The key materiality criterion for the majority of insurers will be the 5%, which reflects the Regulators’ intention for only those categories to be reported that are significant for that particular insurer. The £100 million is intended to ensure that categories which are of
economic significance in absolute terms are not excluded from the return even if they fall below the 5% limit for the insurer. This will clearly only affect the very largest insurers, as gross written premiums or gross undiscounted provisions would need to exceed £2,000 million for the £100 million test to be relevant. Conversely, the £1 million test is designed to achieve proportionality in terms of the reporting requirements imposed on smaller insurers. If a small insurer does not have any combined (or miscellaneous or 160/330) category for which either gross written premiums or gross undiscounted provisions exceed £1 million, then it will only complete Forms 20 to 25 for the super-combined categories and the balancing categories, and will not need to complete Forms 26 to 29, 31, 32 and 34 at all.

2.11. The Regulators also recognise that for many insurers in run-off, the information about historical development provided in the Forms prepared for the secondary subdivisions is unlikely to be of much value for the purposes of supervision, either because the run-off has settled down or because the nature of the business is unpredictable. A waiver by consent is available to enable Forms 26 to 29, 31, 32 and 34 to be omitted from the return. The streamlined procedure is available to an insurer in run-off that has had its permission to effect contracts of insurance cancelled and which has gross technical provisions for each reporting category of less than £100 million. This concession is not automatic: the insurer will need to complete a questionnaire (downloadable from the PRA website) and the supervisor will have to agree.

2.12. It is not obligatory to take advantage of the _de minimis_ limits, and an insurer could choose to report a category even though it fell below the limits. Although this has not been something that the Regulators would encourage, the application of the _de minimis_ limits can be complex and some insurers find it easier to report all categories, particularly if they have only few categories. It would in any case be logical to report a category if it was only marginally below the limit, and there was some likelihood that it would exceed the limit in a subsequent financial year.

2.13. Rule 9.20A represents an important qualification to the _de minimis_ rules for the secondary subdivisions only. This provides that if the Forms 26 to 29, 31, 32 and 34 prepared under the normal rules do not result in categories being reported which account for at least 80% of the gross undiscounted provisions, then with certain provisos additional Forms must be prepared for further categories of business, in decreasing order of size (measured in gross undiscounted provisions) until the 80% criterion is satisfied. With the _de minimis_ rules being based not on the risk category as a whole but on the risk category for a currency for a reporting territory, there is otherwise a danger that the extent of subdivision might lead to so much business falling below the _de minimis_ limit that insufficient categories would be reported to enable sound conclusions to be drawn as to the adequacy of the technical provisions. To avoid the need at the other extreme for small insurers to report immaterial categories in order to meet the 80% test, the 80% test is itself subject to materiality thresholds. It is unnecessary to report a risk category (in a currency in a reporting territory) if:

(a) gross written premiums for the financial year and gross undiscounted provisions as at the end of the financial year for that category are both less than £1 million; or

(b) the combined category into which the risk category falls, or the miscellaneous category or 160/330 to which it belongs falls below the basic _de minimis_ limits and does not have to be reported on Form 20.

2.14. Underlying working papers will be necessary to document the application of the 80% test, since gross unearned premiums are not reported on any of the prescribed Forms for the secondary subdivisions.

2.15. The _de minimis_ limits will determine which categories have to be reported on Forms 20 to 29, 31, 32 and 34. However, the _de minimis_ limits do not apply to Form 20A and this Form will

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109 The balancing category Forms would be required in these circumstances even though the figures reported would be the same as those appearing on the category 002 and 003 Forms.
therefore report all business by reference to its true underlying risk category. Form 20A runs to three sheets and has a large number of supplementary notes. Sheet 1 deals with the primary subdivisions and sheets 2 and 3 with the secondary subdivisions. Four columns are provided, dealing respectively with gross premiums written (1), gross reported and incurred but not reported undiscounted outstanding claims at the end of the financial year (2 and 3) and the gross provision for unearned premiums at the end of the financial year (4). Within the Form, the figures at line 1 for super-combined category 001 will need to agree to the sum of super-combined categories 002 (line 2) and 003 (line 3), to the sum of the primary subdivisions (lines 4 to 18) at line 20 and to the sum of the secondary subdivisions (lines 21 to 101) at line 111.

2.16. The Instructions to Form 20A indicate the cells on the underlying Forms to which the figures in columns 1 to 4 should agree. The *de minimis* limits mean, of course, that the underlying Forms will not necessarily be prepared for a given category, so the relationships are articulated in terms of the figures that would appear on the Forms if these were required. The premium sources refer to Forms 21, 24 and 25 whereas the claims sources refer to Forms 27, 29, 31, 32 and 34: these differing formulations seem unavoidable given that gross premiums written and gross unearned premiums are not reported on Form 27, 31 or 32 (which indicate gross premiums earned), while a gross outstanding/IBNR split is not available on Form 22 or 23. The prescribed sources are as follows.

► Column 1 (gross written premiums): Form 21 lines 11 + 12 + 13 + 14 + 15 columns 1 and 2 plus Form 24.11.12\(^{110}\) as if Forms 21 or 25 were required for that category. The total figures in this column will normally agree to Form 11.11.1. If they do not, a supplementary note (code 20AI) is required.

► Column 2 (gross undiscounted outstanding claims): the sum of Form 27.29.5 + Form 29.11.12, converted to sterling if appropriate, over all currencies or the sum of Form 31/32.30.5 + Form 34.30.3 over all the currencies and territories for that category as if Forms 27, 29, 31, 32 or 34 were required for all business.

► Column 3 (gross incurred but not reported claims): the sum of Form 27.29.6 + Form 29.13.12, converted to sterling if appropriate, over all currencies or the sum of Form 31/32.30.6 + Form 34.30.4 over all the currencies and territories for that category as if Forms 27, 29, 31, 32 or 34 were required for all business.

► Column 4 (gross unearned premium provision): Form 21.19.2 + Form 25.22.12 as if Forms 21 or 25 were required for that category, plus the reinsurers’ share of the technical provision for gross unearned premium for business accounted for on an underwriting year basis (since Form 25 line 22 shows a net provision) in that category. The total figures in this column will normally agree to Form 15.11.1. If they do not, this difference must also be explained in supplementary note 20AI.

2.17. There is clearly a relationship between the columns on Form 20A and the *de minimis* limits, but it is not a perfect correlation for the gross undiscounted provisions test, because of the absence of any column for the unexpired risks provision which forms part of the definition of “gross undiscounted provisions”. Although Form 20A will give clear expectations as to the combined categories that need to be reported (but not necessarily the risk categories as materiality is applied at the currency level), the calculation of the *de minimis* limits will need to be made by reference to the true underlying figures, including any unexpired risks provision.

2.18. No fewer than 12 supplementary notes have been prescribed in relation to Form 20A. Several of these are more appropriately addressed elsewhere in this booklet (e.g. supplementary notes relating to specific risk categories are considered in section 5 of this chapter). The remaining supplementary notes are as follows:

\(^{110}\) The total column, i.e. the twelfth from the left, on Form 24 (and on Form 25) is actually referenced as 99-99.
20Ae requires disclosure of the facultative reinsurance element of super-combined category 002 (total primary (direct) and facultative business). The note is necessary to provide relevant information in view of the EU Directive on the reorganisation and winding up of insurance undertakings. Paragraph 7(2) of Appendix 9.2 allows the insurer to make reasonable estimates of the amounts reported.

20Ah requires disclosure for each risk category, where business has been transferred to the insurer from another insurer during the financial year, of:

(a) the date of the transfer

(b) whether the transfer was approved under Part 7 of FSMA or by the competent authority of another EEA State under Article 12 of Council Directive 92/49/EEC or was effected by novation

(c) any amounts included in columns 1, 2, 3 and 4 of Form 20A in respect of consideration for the transfer

(d) the earliest and latest dates upon which the relevant policies incept

(e) whether any of the policies has a duration of longer than 12 months and, if so, the date by which all policies will have expired.

There is a de minimis provision for novations (but not approved transfers) if the consideration does not exceed in aggregate 2.5% of the insurer’s gross premium income for the financial year in question.

20Ai requires ongoing disclosures where there has been a transfer of business in the past which impacts on a risk category for which any of Forms 26 to 29, 31, 32 and 34 have to be prepared. In such a case it is necessary to disclose in the supplementary note the amount included in Form 20A for the risk category in columns 2 plus 3 and column 4 that is attributable to the transferred policies. The main reason for requiring this is understood to be to indicate to users of the return business which may be subject to greater reserving risk because the insurer would have had less underwriting control. Disclosures for a category are only required if the amount included in column 2 + column 3 + column 4 on Form 20A that arises from transferred business exceeds £10 million or the higher of £1 million and 10% of the amount shown in column 2 + column 3 + column 4 of Form 20A for that risk category as a whole.

2.19. If any out of Forms 26 to 29, 31, 32 and 34 are prepared in a currency other than sterling, Form 36 must be prepared to list the exchange rates used. This Form does no more than state name of currency, currency code (from the list at paragraph 31 of Appendix 9.2) and the number of units to £ sterling. The actual exchange rate used, and not than a rounded equivalent should be stated – an exchange rate is not regarded as a ratio in this respect. This enables a mathematical check to be run on Forms 31, 32 and 34 between the currency totals at line 29 and the sterling equivalents at line 30. Form 36 is not used to give any other exchange rates. Thus an insurer with a small amount of non-sterling business that does not have to complete any Forms in currency would not need to indicate on Form 36 the underlying exchange rates used in arriving at the sterling figures reported on Form 20 to 25. Sterling should not appear on Form 36. Under the foreign currency translation rules, it is possible for one rate to be used for income and expenditure during the year but a different rate to be used for translating the closing technical provisions. Where this is the case, Instruction 2 to Form 36 requires the income and expenditure rate to be used.

3. Accident year accounting (Forms 21 to 23)

3.1. The Insurance Accounts Directive permitted fund accounting as a member state option (which the United Kingdom exercised), as an alternative to annual determination of underwriting results. However the ABI SORP states that underwriting results should be determined on an annual basis and carrying profits forward as a liability is not permitted by
IFRS; consequently, fund accounting is unlikely to be encountered in practice. The distinction between accident year accounting and underwriting year accounting therefore represents little more now than two different (and perfectly valid) arrangements of run-off statistics, analysing claim incidents according to the date of the incident in the former case and the inception date of the policy to which they relate in the latter. In both cases, technical provisions are estimated at each period end and an underwriting result is determined. Because many of the Forms in Appendix 9.2 are concerned with the presentation of claims history, separate Forms are used for business accounted for on the two bases. It is unfortunate that the design of the underwriting year Forms still primarily reflects the now obsolete practice of fund accounting rather than feeding an analysis of the technical account into Form 20 in a more consistent manner with the accident year Forms.

3.2. Where an insurer applies accident year accounting there are four Forms to be completed in respect of the primary subdivisions for whichever categories have to be reported under the principles considered in the previous section:

► Form 20, which is a summary technical account
► Form 21, which analyses premiums receivable
► Form 22, which shows the derivation of claims and expenses incurred
► Form 23, which provides claims run-off analysis.

Each of these Forms will be considered in detail in this section.

3.3. Form 20 introduces a valuable distinction, between the balance of the year’s underwriting (line 19) and adjustments for previous years’ underwriting (line 29). An insurer will hardly ever be in a position to calculate the provision for outstanding claims at a year end to such a degree of accuracy that this figure equates precisely to subsequent payments. However, such movements on the run-off of old accident years, which may represent either improvement or deterioration, can make it difficult to interpret published technical accounts, since a technical loss may in fact represent a profit in respect of the insurer’s exposure to risk during the financial year which is more than offset by deterioration in respect of the old years. Schedule 3 does require a note to the accounts where there is a material difference between the loss provision made at the beginning of the year for outstanding claims incurred in previous years and the sum of the payments made during the year on account of claims incurred in previous years and the loss provision shown at the end of the year for such outstanding claims. The Schedule 3 requirement is to disclose the difference, analysed by category and amount. However, by splitting out such movements regardless of materiality, together with movements in other technical account items, Form 20 provides, for accident year accounting at least, a clear indication of the relative importance of these two factors for each category in arriving at the balance of all years’ underwriting (line 49), and represents a far more comprehensive disclosure requirement.

3.4. Form 20 is drawn up to report figures net of reinsurance; the majority of figures are derived directly from Forms 21 and 22 on which gross and reinsurance figures are reported separately. The only figures not derived from other Forms or representing totals are those at lines 16 and 25 (other technical income or charges) and 51 (allocated investment return). If there is a figure at line 16 or 25, particulars have to be specified by way of supplementary note (code 2005).

3.5. Form 21, which provides an analysis of premiums, has a straightforward columnar structure showing earned and unearned premiums separately for gross (columns 1 and 2), reinsurance ceded (columns 3 and 4) and net (columns 5 and 6). An insurer is required to

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111 Whilst an underwriting year of a Lloyd's syndicate still remains in existence for three calendar years before a profit or loss is distributed to the syndicate members, this reflects the legal nature of the syndicate as a venture operating for a specific period rather than a basis of financial accounting for ongoing business of an insurance undertaking. Financial reporting of business in the Lloyd's market has for several years now been performed on an annual accounting basis.
state in a supplementary note to Form 21 (code 2102) the basis on which unearned premiums are calculated and the reason for adopting that basis.

3.6. Form 21 consists of seven lines with the final line (19) providing a total of lines 12 to 16 for carry forward to Forms 15 and 20. Lines 11 and 12 relate to late booked premiums which should have been recognised in previous years’ returns; proper accruing for pipeline premiums should lead to the figures included at these lines being minimal although entries can arise where, for example, adjustments to employers’ liability premiums can only be determined finally when the size of the payroll is known. Two lines are required, in order to distinguish that part of the premium which was earned in a previous financial year (and therefore has no relevance to the current year’s underwriting) (line 11) from that which is either earned in the current financial year, or in the case of long period risks is unearned at the end of it (line 12). Premiums relating to risks incepted in the present financial year have to be broken down three ways into risks for periods of less than 12 months (line 13), risks for periods of 12 months (line 14) and risks for periods of more than 12 months (line 15). Finally line 16 brings in unearned premiums brought forward, and line 19 provides totals for premiums earned in the financial year and unearned premiums at the end of the financial year.

3.7. Instruction 1 to Form 21 indicates that lines 13 to 15 should include premiums actually received prior to the financial year but relating to risks incepted in the financial year, and exclude premiums received during the financial year but relating to risks incepting after the end of the financial year. It is possible that an insurer may have adopted a different treatment in its accounts, by including the latter type of item both in premiums written and in unearned premiums carried forward. Where this is the case, Instruction 1 to Form 21 indicates that Forms 13 and 15 should be prepared on the same basis as the accounts, with the difference in unearned premiums carried forward between these Forms and Form 21 being identified and explained in supplementary note 2103.

3.8. One minor drawback of the Form is that it is not particularly simple to tie in figures to the accounts. The mandatory disclosures in the Schedule 3 general insurance business technical account equate to the following cells on Form 21:

| Gross premiums written | X | sum of 21.11.1 to 21.15.1 plus the sum of 21.12.2 to 21.15.2 |
| Outward reinsurance premiums | X | sum of 21.11.3 to 21.15.3 plus the sum of 21.12.4 to 21.15.4 |
| Net premiums written | X | sum of 21.11.5 to 21.15.5 plus the sum of 21.12.6 to 21.15.6 |
| Change in the gross provision for unearned premiums | | 21.19.2 - [21.16.1 + 21.16.2] |
| Change in the provision for unearned premiums - reinsurers’ share | X | 21.19.4 - [21.16.3 + 21.16.4] |
| Change in the net provision for unearned premiums | X | 21.19.6 - [21.16.5 + 21.16.6] |
| Earned premiums, net of reinsurance | X | 21.11.5 + 21.19.5 |

3.9. Form 22 provides an analysis of claims, expenses and certain technical provisions. Claims (including claims management costs) are dealt with at lines 11 to 18, the provision for unexpired risks at line 19 and expenses at lines 21 to 29. The remaining lines show adjustments for discounting and provide current and prior year splits. There are four columns dealing respectively with:

1. amount brought forward from previous financial year
2. amount payable/receivable in the financial year

3. amount carried forward to next financial year

4. amount attributable to the financial year.

3.10. Care needs to be taken in arriving at the column 4 figures on this Form. In the case of claims, claims incurred will represent claims paid plus outstanding claims carried forward less outstanding claims brought forward (i.e. 2 + 3 – 1), and a similar logic applies to the related claims management costs and discounting adjustments. However, for commission payable any carry forward will represent commission paid in the financial year giving rise to a benefit in the next year, and to arrive at the figure to be charged in the revenue account it is necessary to take 1 + 2 – 3 (likewise for other acquisition expenses and reinsurance commissions receivable).

3.11. The claims analysis at lines 11 to 18 distinguishes between claims arising from incidents occurring in previous financial years (11 to 14), and claims arising from incidents occurring in the financial year (15 to 18). Under the insurance accounts rules, claims include all internal and external claims management costs, and the claims provision on Form 15 reflects all such items. However, for the purposes of the revenue account Forms, those claims management costs which are not directly attributable to particular claims (e.g. salaries and overheads of the claims department) are separately identified, and in the case of Form 22 appear at lines 14 and 18. Claims statistics in the 30 series have always been prepared exclusive of such items, as have Forms 23, 26 and 27.

3.12. The Accounts and Statements Rules include important supplementary note disclosures (code 2202) in relation to claims management expenses, covering three matters (Appendix 9.2 paragraph 22).

1. The basis used for the determination of amounts for claims management costs payable in the financial year and carried forward to the following year must be specified. The repealed Guidance Note 9.1 indicated that the FSA expected the “payable” part of the disclosure to include an explanation of how overheads are allocated as between claims management costs and net operating expenses.

2. If for any reporting category there is no amount carried forward for claims management costs but there is a provision for outstanding claims, the reason for anticipating that there will be no claims management costs incurred in running off these claims is to be stated.

3. If an insurer has ceased during the financial year to effect new contracts of insurance within a reporting category, the basis upon which any additional costs arising as a result of the cessation have been determined, or the reason for anticipating that no such additional costs will be incurred is to be stated.

3.13. A further supplementary note (code 2203) is required if the provision for claims management costs carried forward has been determined after taking into account expected investment return, to state the rates of investment return assumed and the average interval between the end of the financial year and the date by which the claims management costs are expected to be expended.

3.14. The provision for unexpired risks is dealt with on Form 22 at line 19. By the nature of the item there will never be a payable/receivable figure in column 2, so this box has been shaded. The principles relating to the establishment of the provision are set out in paragraphs 19 and 20 of Appendix 9.2. Each category reported on Form 22 needs to be considered separately for the purpose of determining whether an unexpired risk provision is necessary, in the light of the relationship between the amount considered necessary to meet the cost of claims and expenses of settlement of that reporting category arising from risks to be borne after the end of the financial year, and the unearned premium provision for that category considered in isolation. Paragraph 118 of the ABI SORP allows an assessment of whether an unexpired
risks provision is necessary in the accounts to be made for each grouping of business which
is managed together, with any unexpired risk surpluses and deficits within that grouping
being offset. Business is only to be regarded as managed together (paragraph 119) where no
constraints exist on the ability to use assets held in relation to such business to meet any of
the associated liabilities and either:

(a) there are significant common characteristics which are relevant to the assessment of
risk and setting of premiums for the business lines in question; or

(b) the lines of business are written together as separate parts of the same insurance
contracts.

3.15. Although similar offsets can be applied in the return in determining the overall provision at
Form 15 line 13 less Form 13 line 62 (provided that the resulting net provision is not
negative), this needs to be done explicitly, by including appropriate positive and negative
provisions on the Forms 22 for the categories between which offsets have been applied.\(^\text{112}\) If
any Form 22 provision has been determined after taking into account the expected
investment return, a supplementary note (code 2205) is required to state:

(a) the provision for unexpired risks before taking such investment return into account;

(b) the rates of investment return assumed; and

(c) the average interval between the end of the financial year and the date at which
claims are expected to be settled in cash.

3.16. The analysis of expenses is relatively straightforward. Lines 23 and 24 correspond to specific
disclosure items under the Schedule 3 format, while lines 21 and 22 split out the commission
and other elements of acquisition costs. One point which does need to be stressed in the
context of these lines is that column 2 deals with expenses payable, not expenses paid (i.e.
the expense for the financial year, not the cash flow). The purpose of columns 1 and 3 is
therefore not to pick up opening and closing creditors for items which are due but not paid,
but to time apportion the benefit of the expenses over more than one financial year. For
commission, this is reasonably obvious since whereas a broker’s commission will normally
have been settled “up front” by the broker deducting the relevant amount from the premium
paid over to the insurer, part of that premium is carried forward as unearned to the following
financial year, and it is only logical to match a corresponding proportion of the commission
against this. Other acquisition expenses will require similar treatment, but there is no basis
for carrying forward administrative expenses that do not represent acquisition costs.
Consequently the column 1 and 3 cells at line 23 have been shaded on the Form. A
supplementary note (code 2204) is required to specify the basis for determining acquisition
expenses (other than commission) paid and carried forward. The recommendation of the
repealed Guidance Note 9.1 that the “payable” part of the disclosure should include an
explanation of how overheads are allocated as between “other acquisition expenses” and the
other components of “net operating expenses”, especially “administrative expenses” and the
“carried forward” part of the disclosure should include an explanation of how the appropriate
proportion of acquisition expenses (other than commission) to match the unearned premium
carried forward was determined should continue to be followed.

3.17. Form 23 is intended to present clearly and concisely for each category the historical and
recent claims reserving and profitability. The columns on the Form are as follows:

1. Claims paid (net) during the accident year

This is showed separately on the Form so that it is possible at one and the same time to
compute the deterioration or surplus of the original claims reserve in column 12 and the
claims ratio in column 13. For the current accident year, the figure will agree to Form 22.17.2.

\(^\text{112}\) Although this is not explicitly stated by Appendix 9.2, it seems unavoidable that any positive and negative
unexpired risk provision for different categories reported in balancing category 409 on Form 22 would be offset.
2. Claims outstanding (net) as at end of the accident year
This is the base figure by reference to which deterioration is calculated in column 12. For the current accident year, the figure will agree to Form 22.17.3.

3. Total claims paid (net) since the end of the accident year, but prior to the financial year

4. Claims paid (net) during this financial year
These two columns split out the payments made since the end of the accident year into the element paid in the current financial year and the element paid previously. The total of column 4 will agree to 22.13.2 plus 22.17.2, and 23.11.4 will agree to 22.17.2. The column 3 figures for an accident year will correspond to column 3 plus column 4 for that accident year per the previous return as adjusted for exchange movements.

5. Claims outstanding carried forward - reported (net)

6. Claims outstanding carried forward - incurred but not reported (net)
The sum of the totals of these columns will equate to 22.13.3 plus 22.17.3, and 23.11.5 + 23.11.6 will agree to 22.17.3.

7. Claims outstanding brought forward - reported (net)

8. Claims outstanding brought forward - incurred but not reported (net)
These are the brought forward equivalents of lines 5 and 6 and will correspond, subject to exchange movements, to the carried forward figures on the previous year’s return. Inclusion of these columns enables the improvement or deterioration in the year to be calculated in column 9. The total of these two columns will equate to 22.13.1.

9. Claims incurred (latest year) or developed (other years) during this financial year
This represents column 4 plus column 5 plus column 6 minus column 7 minus column 8. The total will equate to 22.13.4 plus 22.17.4, and 23.11.9 will agree to 22.17.4.

10. Deduction for discounting from claims outstanding carried forward (net)
As explained in paragraph 4.3 of chapter 5, the revenue accounting Forms generally report claims gross of any discounting adjustments. This column serves to analyse the discounting adjustments at 22.31.3 minus 22.32.3 by accident year.

11. Earned premiums (net)
This disclosure enables claims ratios (claims incurred as a percentage of earned premiums) to be calculated. The figure for the current accident year can be obtained from Form 21.19.5; the earned premium figures for previous accident years should be updated each year to take account of over- or under-estimates of premium.

12. Deterioration/(surplus) of original claims reserve
This is the ratio of columns 3 + 4 + 5 + 6 - 2 to column 2, expressed as a percentage to one decimal place (although most ratios in the return must be expressed to two decimal places, Instruction 10 to the Form prescribes only one).

13. Claims ratio
This is the ratio of columns 1 + 3 + 4 + 5 + 6 to column 11, expressed as a percentage to one decimal place, and enables the trend of the profitability of the business to be seen at a glance.

3.18. There are several points to watch in the completion of Form 23.
The Form provides information for the current and nine previous accident years, a reporting period which also features on Forms 31, 32 and 34 (save for certain liability risk categories which go back further on those Forms).

Line 21 deals with prior accident years in aggregate.

All figures on the Form exclude claims management costs.

For the 1996 and subsequent accident years, it is necessary to maintain separate underlying records for each currency and to retranslate figures in columns 1, 2, 3 and 11 of the Form at the current closing exchange rate. Prior to 1996, the interpretation of Form 23 has been rendered difficult by the mixture of exchange rates that may have been used in compiling the Form.

The information presented in columns 12 and 13 will be of particular interest to the FSA and other readers of the return. Consistent under-reserving and consistent unprofitability are two key factors in insurer failures, and the ability to assess the pattern in these two areas at a glance in relation to a particular insurer, and to compare it with a peer group (so as to isolate company-specific problems from industry-wide profitability trends) is likely to prove a valuable tool in identifying potential problems. HM Revenue & Customs is also likely to take a close interest in column 12, although its focus will be the opposite to that of the FSA since it will be concerned to identify consistent over-reserving leading to what it would regard as an excessive tax deduction for claims provisions.

**4. Underwriting year accounting (Forms 24 and 25)**

As discussed at paragraph 3.1 above, underwriting year accounting relates to the method whereby an insurer analyses its claims patterns by relation to the date on which a policy incepts as opposed to the date on which an incident occurs. Provided that technical provisions are established for each underwriting year in accordance with the Schedule 3 rules, a technical account produced for business accounted for on an underwriting year basis will look exactly the same as a technical account produced for the same business accounted for on an accident year basis.

If an insurer chooses to maintain its records on an underwriting year basis, it can report on that basis in the return, however once business for a particular period has been reported in the return on either an underwriting year or an accident year basis, the run-off of that business must continue to be reported on the same basis in future returns, even if a different basis is adopted for business subsequently accepted.

The Accounts and Statements Rules retain expanded disclosure requirements for underwriting year business, including some requirements, now obsolete, in relation to the fund carried forward.

Rule 9.15(2) identifies three circumstances, one now obsolete, in which an insurer can legitimately account for business on an underwriting year basis:

(a) where the business in question has been previously reported under the Accounts and Statements Rules on Forms 24 and 25;

(b) business in respect of which the provision for claims outstanding is set using the method described in paragraph 52 of the insurance accounts rules (i.e. the now obsolete funded basis with profit deferral); and

(c) business which has not been previously reported on any Form under the Accounts and Statements Rules and which the insurer accounts for on an underwriting year basis.
4.5. Two important implications flow from this rule. Firstly, an insurer is able, going forward, to mirror the treatment in its accounts in the return. If it records information on an underwriting year basis, the return can follow suit. However, it is not able to make a complete break from the past. If business has previously been reported on an underwriting year basis, then the run-off of the years in question must continue to be reported on Forms 24 and 25, even if the insurer is adopting an accident year basis going forward.

4.6. Accident year accounting is effectively regarded by the Accounts and Statements Rules as the norm, since paragraph 24 of Appendix 9.2 requires that where underwriting year accounting is adopted, a supplementary note (code 2402) relating to the financial year in respect of each category is included to state:

(a) the reason for accounting for such business on an underwriting year basis;

(b) the basis for distinguishing between such business and any other business falling within the same reporting category accounted for on an accident year basis; and

(c) the accounting policy adopted for determining the provision for claims outstanding; and

(d) if the information provided in (a) to (c) differs in respect of risks incepted in the financial year in question from risks of a similar description incepted in previous financial years, the reason for the difference.

4.7. The key implication of a decision to adopt underwriting year accounting is that contracts of insurance are allocated to underwriting years for the purposes of the statistical analysis of claims patterns within the return. Allocation is determined by the date on which a contract of insurance incepts; policies received under a transfer are deemed to incept on the date of the transfer (Appendix 9.2 paragraph 11) while a policy providing continuous cover is deemed to incept on each anniversary of the contract. Of continuing validity is the recommendation of paragraph 8.2(12) of the repealed Guidance Note 9.1 that net operating expenses should be allocated to underwriting years so as to match the premium earned and claims incurred to which they relate. In many cases it may be appropriate to allocate most or all of the administrative expenses to the youngest underwriting year (except for over- or under-provisions of such expenses at the previous year end).

4.8. For business accounted for on an underwriting year basis, Form 20 includes the balance from Form 24 (line 31), other technical income and charges (line 32) and a total (line 39). If an insurer has an entry at line 32 (which corresponds to an item in the Schedule 3 technical account), it is necessary to provide particulars in supplementary note 2005. It is Form 24 that continues to be the key Form for analysing underwriting year business. The right hand column (coded as “99-99”) represents the total of all previous columns while the left hand column (coded as “29-29”) represents prior underwriting years for which individual details are not provided on one of the ten central columns. These central columns deal with the underwriting years corresponding to the present and previous nine underwriting years, with the most recent year on the right.

4.9. Vertically, Form 24 is divided into four main sections:

► lines 11 to 19 dealing with premiums

► lines 21 to 39 dealing with claims and claims management costs

► lines 41 to 49 dealing with operating expenses

► lines 51 to 59 dealing with technical provisions.

113 A firm may apply for a modification under section 138A of FSMA, disapplying this rule to specific transactions, so that the run-off history can be preserved in the receiving firm’s PRA return.
Line 69 is described as “Balance on each underwriting year”; since it is arrived at by comparing the actual increase in technical provisions with the excess of premiums over claims and expenses, it represents the transfer into or out of the technical provisions as a result of the year-end assessment as to their adequacy.

4.10. The disclosure of gross premiums receivable and reinsurance premiums payable in arriving at net premiums receivable has already been encountered in the context of Form 21. These figures must be stated gross of commission. The claims and expenses sections are relatively straightforward; the only specific comment that needs to be made is that net operating expenses should not include the increase or decrease in deferred acquisition costs as this is dealt with as part of the movement in technical provisions. Premiums and claims are on a written and paid basis rather than an earned and incurred basis, since the brought and carried forward technical provisions are dealt with at lines 51 to 59.

4.11. Form 25 provides an analysis of technical provisions which, now that underwriting years are not left ‘open’, are equivalent to those that are calculated for accident year accounting. Lines 19 and 20, showing respectively offsets and the balance of the fund carried forward, will always now be blank, and the associated supplementary note 2504 will not be present. Lines 11 to 18 and 21 dealing with claims outstanding, lines 22 to 25 dealing with other technical provisions and the total line (29) have to be completed. The sub-analysis of claims outstanding corresponds to information required for accident year accounting on Form 22 (gross, reinsurance, claims management costs and adjustment for discounting) or Form 23 (the split between notified outstandings and IBNR) and does not call for particular comment. The remaining technical provisions to be shown are the unearned premium provision (line 22), the unexpired risks provision (line 23), deferred acquisition costs (line 24) and “other” (line 25). For a relatively old year there may well be nothing to disclose at these lines, although unearned premiums and deferred acquisition costs will certainly be required for at least the youngest underwriting year. The considerations relating to these lines are the same as for the accident year equivalents on Forms 21 and 22. Supplementary notes similar to those already encountered in considering accident year accounting are required in respect of:

(a) the basis for determining claims management expenses payable and carried forward, including an explanation of the absence of claims management expenses carried forward where there are claims outstanding carried forward and the basis of additional costs arising from the cessation of new business in any reporting category (code 2404)

(b) rates of interest and average interval assumed for any reporting category where investment income has been taken into account in determining the claims management costs carried forward (code 2405)

(c) the basis for determining acquisition costs other than commission payable and carried forward (code 2406)

(d) the basis on which the provision for unearned premiums is calculated and the reason for adopting that basis (code 2501)

(e) for any reporting category for which investment income has been taken into account in determining the provision for unexpired risks, the undiscounted provision, the rates of interest used and the average interval to the date at which claims are expected to be settled in cash (code 2502)

(f) particulars of any “other” technical provisions included at line 25 (code 2505).

It should be noted that the disclosures at lines 21 to 25 are all net of reinsurance and it is therefore not possible to prove mathematically the gross provisions on Form 15 to the technical account.
5. **Direct and facultative risk categories (Forms 31, 32 and 34)**

5.1. Forms 31, 32 and 34 are used to report risk and miscellaneous categories of direct and facultative business which exceed the *de minimis* limits, or which have to be reported by virtue of the 80% principle of rule 9.20A. The Forms are used as follows:

- Form 31 for business accounted for on an accident year basis other than motor
- Form 32 for motor business accounted for on an accident year basis
- Form 34 for business accounted for on an underwriting year basis.

5.2. The primary emphasis of these Forms is on currency rather than country. A limited concept of reporting territories is retained, both for reporting purposes and for the application of the *de minimis* rules, but there are only three reporting territories:

(a) ‘United Kingdom’ if the business is carried on in the United Kingdom and is not home foreign business;

(b) ‘Home Foreign’ if the business is home foreign business (defined by Chapter 11 as “general insurance business carried on in the United Kingdom primarily relating to risks situated outside the United Kingdom, but excluding insurance business in category numbers 330, 340, 350, 500, 600 and 700 and insurance business where the risk commences in the United Kingdom” – in other words, limited to direct and facultative business other than marine, aviation and goods in transit); and

(c) ‘Non-United Kingdom’ if the business is carried on outside the United Kingdom.

5.3. In completing the Forms, heading information relating to reporting territory is required both in the words and in the computer part of the heading. The words are prescribed by paragraph 16(3) of Appendix 9.2 and the codes by paragraph 32. For risk categories which are subsets of 330 or 340 or comprise 350 (to which the concept of reporting territories is not applied), the words ‘World wide’ will be used, together with the code WW. Paragraph 16(3) requires risk category 400 also to be reported as ‘World wide’ with the same code, notwithstanding that it is not excluded from the definition of home foreign business. For other risk categories, the appropriate words and coding are:

- United Kingdom – AA
- Home Foreign – AB
- Non-United Kingdom - XX

5.4. Because of the *de minimis* limits, the full extent of the home foreign and non-United Kingdom elements of the business may not be evident from the Forms prepared. Consequently, paragraph 16(1) of Appendix 9.2 requires an analysis in supplementary note 20Ag for a risk category of:

(a) the United Kingdom, home foreign and overseas elements of gross written premiums in column 1, if there are any home foreign or overseas elements; and

(b) where any of the business reported in Form 20A for the risk category is attributable to overseas business, and is not treaty reinsurance business, the names of the countries where business in the risk category is carried on.

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114 Historically, some insurers had to prepare a large number of Forms, as information was required separately for each country. This is no longer the case, with only the three reporting territories discussed in this paragraph. Statistical information for direct business within the EEA on a country by country basis must still be provided, separately from the return, under rule 9.37 – see section 2 of chapter 11.
5.5. The first of these requirements is not limited to those risk categories that are capable of being classified as home foreign, neither does it exclude those that are required to be reported on Forms 31, 32 and 34 as ‘World wide’. Business that is excluded from the definition of home foreign cannot, clearly, be classified as such, but paragraph 16(2) of Appendix 9.2 indicates that overseas business will be, for direct and facultative business, business for which the contract was not effected in the United Kingdom, and for reinsurance treaties, business where the cedant’s head office is not in the United Kingdom (and the cedant is not a member of Lloyd’s). The requirement to disclose the names of the countries where the overseas business is carried on, however, applies only to direct and facultative business.

5.6. An interesting feature of the prescribed categories is the presence of the mixed commercial package category (274). This encompasses direct and facultative insurance contracts providing coverage against more than one of:

(a) loss or damage to property
(b) risks to the persons insured incurring liabilities to third parties
(c) risks of loss to the persons insured arising from the failure of debtors of theirs to pay their debts when due
(d) risks of loss to the persons insured attributable to interruptions of business carried on by them
(e) risks of loss to the persons insured attributable to their incurring unforeseen expenses
(f) any other risk of loss to a commercial operation

where the risks and losses covered in the contract are rated on a single package basis and no separately identifiable premium is charged or recorded for internal management purposes for any one group of risks or losses specified in the contract. Two comments are appropriate in respect of this category.

► The fact that a variety of risks are grouped together in one category for completing a set of revenue accounting Forms does not of itself affect the need to consider elements on an unbundled basis elsewhere in the return. The liability element of the category should still be the subject of class enhancement on Forms 11 and 12, while only the elements falling within the prescribed insurance business groupings should be included in the equalisation provision calculations on Forms 37 to 39. A degree of unbundling is, in any event, required by supplementary note 20Af (see paragraph 5.8 below).

► There is an inherent tension within the definitions of Annex 11.3 in that the definition of the mixed commercial package category 274 specifically excludes contracts that fall into category 261 (commercial property), whereas the definition of category 261 specifically excludes contracts that fall, inter alia, into category 274. A suggested resolution of this is that if a contract covers purely commercial property and consequential loss on a package basis, it is reported in 261, but if there is any additional element, it is reported in 274.

5.7. Categories 187 (other personal financial loss) and 223 (motor other) are both of a sweep up nature. These deal, respectively, with direct and facultative insurance contracts which cover the following perils:

► 187 – risks of loss to a person (who is not a body corporate or partnership) attributable to loss, breakdown or reduction in value to a personal item that attach to a purchase of that item, or to an event not taking place as planned, and which do not fall within categories 113, 160 or 181 to 186.
Chapter 6 – Revenue accounting – general insurance business

223 – risks within authorisation classes 3 (land vehicles) and 10 (motor vehicle liability) which do not fall within category numbers 120, 221 or 222. This would include contracts relating to motor trade and taxis.

Unsurprisingly, a detailed analysis of business included in these categories is required to be included in supplementary note 20Ac, which as explained earlier also requires such disclosures in respect of the miscellaneous categories 400 and 700.

5.8. Two further disclosures relating to the business within risk categories are required in the supplementary notes to Form 20A.

(a) 20Ad requires disclosure, for each risk category where the Form 20A figures contain both claims-made policies and policies that are not claims made, of the amounts reported on the Form which are attributable to each type of policy. Reasonable estimates may be used. This disclosure replaces the previous requirement to allocate claims-made policies to different risk groups from policies that were not claims-made. A claims-made policy is defined as a contract of liability insurance which provides that no liability is incurred by an insurer in respect of an incident unless the incident is notified to the insurer (or its agent or its representative) before the end of a specified period which is no longer than three years following the final date for which protection is provided under the contract.

(b) 20Af requires disclosure of the amounts reported on Form 20A risk categories 113 (travel), 274 (mixed commercial package) and 343 (energy) that have arisen from:

(i). each group of classes in Part II of Annex 11.2 (accident & health, motor, marine and transport, aviation, fire and other damage to property, liability, credit and suretyship and general)

(ii). authorisation classes 16, 17 and 18 combined.

This results in the unbundling of categories that may cover a range of risks – for example the energy category covers both onshore and offshore risks.

5.9. Although these categories have had to be applied to all business written since their introduction in 2005, transitional measures were available in order to avoid specific types of business that had been reported in a particular way in the return having to be reclassified, particularly in situations where cumulative historical data had to be reported. These measures are contained in Chapter 12 of IPRU(INS) and may have some relevance where a firm needs to report current year transactions on business that was already in force at transition. The five areas where an alternative treatment is available in respect of direct and facultative business are as follows:

(a) Commercial package business falling within the definition of category 274 could be reported in category 261, 271 or 273.

(b) Business that had been reported under a single risk group in the return for the financial year immediately preceding the first financial year that ended on or after 31 December 2005, could be reported in a single risk category if 90% or more of the claim liabilities reported under the risk group fell into that single risk category.

(c) Any business covering risks relating to hovercraft which had been classified under the heading 'Aviation' in the return for the financial year immediately preceding the first financial year that ended that ends on or after 31 December 2005, could be reported in any of categories 331 to 333 (aviation).115

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115 The issue here is that hovercraft are specifically referred to in the definition of risk categories 341 (marine liability) and 342 (marine hull) whereas an insurer may previously have classified hovercraft as part of the aviation account.
(d) Any business covering liability for loss of, or damage to, goods in transit which had been classified under the heading 'Transport' in the return for the financial year immediately preceding the first financial year that ended on or after 31 December 2005, could be reported in category 350 (transport).

(e) Any business which had been classified under the heading 'Accident and Health' in the return for the financial year immediately preceding the first financial year that ended on or after 31 December 2005, and which would otherwise have to be allocated to category 114(p), could be reported in category 114.

5.10. The alternative treatment does not apply across the board to these types of business, but is restricted by IPRU(INS) rule 12.1 to:

(a) column 1 to 3 or 11 and rows relating to accident years prior to 1995 on Form 23 (now rolled up into the ‘prior financial years’ at row 21);

(b) column 1 to 3 or 10 and rows relating to accident years prior to 1995 on Form 31 or 32 (again, now rolled up into the ‘prior financial years’ at row 21 on these Forms, except in the case of a Form 31 for a risk category in the range 271 – 274); and

(c) column 1 or 8 and rows relating to underwriting years prior to 1995 on Form 34.

5.11. The limitation to specific columns on the Forms in question meant that there was a lack of consistency in the numbers aggregated to arrive at the loss ratios reported, but this limitation did not concern the Regulator. More seriously, as the Regulator acknowledged in Handbook Notice 49, the provisions as articulated did not achieve their intended purpose. The Regulator had intended to apply the commercial package concession to accident or underwriting years ending prior to 31 December 1996 and the remaining concessions to accident or underwriting years ending prior to 31 December 2005. Although the Handbook Notice accepted that there were problems with the transitional provisions, it regarded the amendments required as going beyond corrections and clarifications and therefore as requiring formal consultation, for which there was not time before the due date for submission of the 2005 returns. Firms could apply for a waiver in order to benefit from the intended arrangements in those returns, and such applications were likely to be considered sympathetically by the Regulator. The issue now seems to have been largely forgotten about, and the rules remain unchanged in Chapter 12.

5.12. The requirements of each of these Forms will now be considered. Thousands of pounds or currency units will normally be employed; if, however, a currency has a closing rate to sterling of more than 1,000 principal monetary units then amounts are to be shown to the nearer 1,000,000 principal monetary units. The units employed will be indicated by inserting either “000” or “000,000” in the box in the computer heading labelled “monetary units”; a £ or other currency sign should not appear in the box since the currency is already indicated by the adjoining currency code box.

5.13. Form 31 analyses gross claims and premiums by required category for business accounted for on an accident year basis (other than motor, which is dealt with on Form 32). A separate Form is required for each reported category. The Form has the following key features:

► On the premium side only a single figure for gross premiums earned has to be disclosed for an accident year (column 10). The figure needs to be stated for each accident year: a transitional provision which now only has practical relevance for risk categories 271 – 274 allows this information (and consequently the claims ratio in column 11) to be omitted for accident years ended before 23 December 1994.

► On the claims side numbers only need to be given for claims closed at some cost during this or previous financial years (column 1) and for reported claims outstanding (column 2). For the purposes of the claim numbers to be given, a reopened claim only counts as a single claim and may need to be transferred from column 1 to column 2 in the year of reopening. Numbers do not have to be given at all for risk
categories 331 to 400 (marine, aviation, goods in transit and the miscellaneous category).

Except for third party liability business (risk categories 271 to 273) only the current and previous nine accident years have to be reported individually; earlier years are grouped and key figures reported in aggregate at line 21. For liability business, one or more continuation sheets will be necessary, since an accident year has to continue being reported until it is fully run-off, although accident years commencing prior to 1 January 1973 can be reported in aggregate.

Brought forward figures for reported claims outstanding (column 7) and IBNR (column 8) are included and enable a balance for each accident year (paid in year plus outstanding minus brought forward) to be stated.

Overall the Form bears a reasonably close family resemblance to Form 23 (which is prepared on a net basis for the primary subdivisions). The main structural differences are the inclusion of claims numbers, the use of one rather than three columns for claims paid in previous financial years and the absence of any equivalent to the Form 23 column 10 stating the deduction for discounting from claims outstanding. All figures on Form 31 are before any deduction for discounting and exclude claims management costs.

Form 32, which is only required in respect of the motor risk categories (121, 122, 123, 221, 222 and 223), has columns 1 to 11 identical to those of Form 31. Its distinguishing feature is the inclusion of two additional columns: column 12 specifying vehicle years and column 13 stating claims frequency. Instruction 6 to the Form indicates that the number of vehicle years insured under any insurance contract is the product of the period (expressed in years and parts of years) for which the contract is in force and the number of vehicles under contract. Figures entered in column 12 are to be rounded to the nearest thousand vehicle years only after aggregating the component figures. “Claims frequency” in column 13 represents the ratio, expressed as a percentage to one place of decimals, of the sum of columns 1 and 2 to the unrounded number of years underpinning column 12.

Form 34 is also similar in design to Form 31. It omits the number of claims columns (which as indicated above do not have to be completed on that Form for marine, aviation and goods in transit business) and reports gross premiums written rather than gross premiums earned, but otherwise reports equivalent information on an underwriting year basis. The use of gross premiums written rather than earned in calculating the claims ratio in column 9 may give rise to an artificially low loss ratio for the youngest underwriting year.

The principle of retranslating historical currency figures at the current closing rate was referred to in the context of Form 23 in paragraph 3.18 above. As Forms 31, 32 and 34 are prepared in original currency, this principle is prescribed only for risk category 400 (miscellaneous) in respect of Form 31 columns 3 and 10 and Form 34 columns 1 and 8.

6. Treaty risk categories (Forms 26 to 29)

The treaty risk categories are predominantly based on the eight groups of classes of business set out in Part II of Annex 11.2 in IPRU(INS), within each of the combined classes 500 for non-proportional business (risk categories 510 to 580) and 600 for proportional business (risk categories 610 to 680). They also include however a ninth risk category in each sub-division (590 and 690 respectively), relating to aggregate cover. This category is used where a risk relates to more than one of the eight underlying categories for non-proportional or proportional business and no one of those categories accounts for more than 90% of the exposure on the contract. A contract which consisted of 80% property and 20% liability would therefore be reported in the aggregate cover category, but if those proportions were (say) 95% and 5% it would be reported in the property category unless a split was justified under rule 9.14B.

If a treaty risk category is reportable, two Forms will need to be completed. For business accounted for on an underwriting year basis (which has traditionally been a common means
of reporting treaty business, and at one time was mandatory), the relevant Forms are 28 and 29. These call for little comment since the design is virtually identical to Forms 24 and 25. A supplementary note at the category level (code 2901) is required where a surplus for offset is shown at Form 29 line 19; as with supplementary note 2504 of which this is the analogue, this note is now obsolete as there will never be an entry at this line or at line 20. A further supplementary note, for which no numbering is prescribed but for which the logical choice would be 2902, is required to provide particulars of any entry at line 25 (analogous to supplementary note 2505). The only specific points of difference on Forms 28 and 29 compared with Forms 24 and 25 are:

(a) The currency needs to be stated; and.

(b) Forms 28 and 29 are open-ended, in that an underwriting year must continue being reported until it is fully run-off, whereas a ten-year cut off applies on Form 24 and 25. Consequently, continuation sheets must be prepared for Forms 28 and 29 to analyse the figures included in the prior underwriting years column (29-29). Underwriting years beginning prior to 1 January 1983 may be reported in aggregate: this concession is extended to underwriting years ended prior to 23 December 1993 for categories 610, 620, 650, 660 and 680 and to underwriting years ended before 31 December 1996 for categories 590 and 690.

6.3. Where an insurer reports the combined categories 500 and 600 on an accident year basis, i.e. on Forms 21 to 23 rather than on Forms 24 and 25, Forms 26 and 27 are prepared for each category above the \textit{de minimis} limits. Again, these call for relatively little comment, since their design is based on an earlier Form, in this case Form 23. Form 26 gives information on net premiums and claims, and Form 27 gives the equivalent information on gross premiums and claims. As was the case with Forms 24 and 25, both Form 26 and Form 27 have their continuation sheets, this time to analyse out the prior accident years' figures appearing at line 21.

7. \textbf{Equalisation provisions (Forms 37 to 39)}

As a result originally of the Insurance Companies (Reserves) Act 1985 (now repealed), insurers carrying on business in the United Kingdom are currently required to establish equalisation provisions for prescribed types of business. These provisions are classified as a technical provision in both the Schedule 3 balance sheet and Form 15 in the return and therefore have solvency implications; however, the insurance industry benefits from the availability of tax relief. Although treatment as a provision is prescribed by the legislation (and has given rise to some controversy in the context of the above the line charge in a set of Schedule 3 accounts that are supposed to give a true and fair view), the true nature of such items is that of a reserve, i.e. a component of equity, and these do not feature in accounts prepared under IFRS.\textsuperscript{116} This booklet will use the term “provision” as this is consistently adopted by INSPRU and by the Accounts and Statements Rules. The rules on the determination of the provision are set out in Chapter 1.4 of INSPRU. Forms 37 to 39 summarise the calculation of the equalisation provision, which appears as a liability at lines 17 (credit insurance) and 18 (other) of Form 15.

7.1. Apart from credit insurance, for which equalisation provisions have been mandatory throughout Europe since the Credit Insurance Directive of 1987 and which remains subject to a different set of rules considered in paragraph 7.8 below, there are five insurance business groupings defined by INSPRU 1.4.12R for which formulae for transfers into and out of the provision and for the maximum provision have been prescribed.

A Property – direct, facultative and proportional contracts falling into general insurance business classes 4, 8 and 9.

\textsuperscript{116} The omission of equalisation provisions from an IFRS balance sheet in no way avoids the need to make a provision in the return, as INSPRU 1.4.10G confirms.
B Consequential loss – direct, facultative and proportional contracts falling into general insurance business class 16(a).

C Marine and Aviation – direct, facultative, proportional and non-proportional contracts falling into general insurance business classes 5, 6, 11 and 12.

D Nuclear – contracts of insurance against nuclear risks (any contracts of this nature are excluded from insurance business groupings A, B, C and E).

E Non-proportional treaty property and consequential loss – non-proportional contracts falling into general insurance business classes 4, 8, 9 and 16(a).

7.2. Although separate calculations are applied to arrive at the transfer in to the equalisation provision for each of these insurance business groupings, the end product of these calculations represents a single provision which can be used in full to cover losses in any grouping, subject to a cap on the transfer out for each grouping based on the maximum provision for that group. An insurer whose head office is not in the United Kingdom only applies the formulae to the premiums and claims relating to the business carried on in the United Kingdom.

7.3. There are a number of steps in the process of determining the equalisation provision, which need to be applied in the order indicated.

1. The transfers in to the provision are calculated in accordance with INSPRU 1.4.27R. This is, for each insurance business grouping, a prescribed percentage of net written premiums.

2. The maximum provision for each insurance business grouping is calculated in accordance with INSPRU 1.4.25R. The maximum represents a prescribed percentage of average net premiums written over the last five financial years (or such fewer years as the insurer has carried on business falling within the insurance business grouping in question). The maximum needs to be calculated at this stage since it represents a cap on the transfer out that is determined in step (3).

3. The transfers out from the provision are calculated in accordance with INSPRU 1.4.31R. A transfer out is triggered by an abnormal loss, defined as a claims ratio in excess of a percentage prescribed for each insurance business grouping. The transfer is the amount represented by the claims ratio in excess of the threshold, except that the transfer out for an insurance business grouping is restricted to the maximum provision for that grouping calculated under (2). The claims ratio represents:

   ► for business accounted for on an accident year basis, net claims incurred in the financial year (taking into account any adjustments in respect of previous years’ underwriting) as a percentage of net premiums earned

   ► For business accounted for on an underwriting year basis, net claims paid plus the increase in the net technical provisions (exclusive of any change in claims handling expenses and any equalisation reserve) in that financial year plus adjustments in respect of all previous financial years as a percentage of net premiums written in that financial year plus adjustments in respect of all previous financial years.

7.4. If, of the above determined amounts, (1) exceeds (3), a net transfer into the provision is made. If (3) exceeds (1) a net transfer out will be made, but is limited by the amount of any equalisation provision brought forward. In either case, if the calculated provision exceeds the aggregate maximum provision calculated under (2), then an additional transfer out must be made to make the equalisation provision equal to the maximum.

7.5. The following table summarises the percentages prescribed by INSPRU 1.4.
Chapter 6 – Revenue accounting – general insurance business

7.6. De minimis limits are prescribed by INSPRU. Under INSPRU 1.4.18R, if an insurer does not have an equalisation provision brought forward, then it is exempt from the requirement to calculate a provision if the amount of annualised net written premiums written for the financial year in respect of the five insurance business groupings in aggregate is less than the threshold amount. The threshold amount (which is not subject to indexation) is defined as the higher of:

(a) €1,500,000 and

(b) 4% of net premiums written in that financial year in respect of the insurer’s entire general insurance business, if this amount is less than €2,500,000.

7.7. This is a “mandatory” de minimis rule, in that if an insurer falls below the limit, INSPRU 1.4.20R does not apply: it does not have the option to establish a provision voluntarily and have it regarded as a statutory equalisation provision. The correct approach in completing the return in these circumstances would be for the insurer to omit Form 37 and include supplementary note 3700 to explain that its net premiums for the insurance business groupings fell below the de minimis limit. Matters are slightly more complicated if an insurer’s premiums are below the threshold amount for the present financial year, but there is an equalisation provision brought forward. In this case, a calculation has to be carried out that takes into account net premiums for the insurance business groupings for previous financial years. An insurer can make a transfer out of the provision to reduce it to zero provided that:

(a) if it has been carrying on non-credit insurance business for at least five financial years, net premiums are also below the limit for two of the previous four financial years or

(b) if it has been carrying on non-credit insurance business for less than five financial years, the average net premiums for that period are less than the limit.

In both cases, figures need to be annualised for any financial year that is not twelve months in duration. If this criterion is not satisfied, a provision is carried forward in the normal way.

7.8. Unlike the non-credit equalisation provision, the credit equalisation provision applies to the global business of a non-EEA insurer (other than a Swiss general insurer and an EEA
Although the Credit Insurance Directive allows any of four methods to be used, INSPRU 1.4.45R requires the use of method 1 whose main features are as follows:

(a) If there is a technical surplus, 75% of this must be transferred in. A technical surplus is defined as:

(i). for business accounted for on an accident year basis, the amount by which the aggregate of net premiums earned and other technical income exceeds the aggregate of net claims incurred, claims management costs and any technical charges;

(ii). for business which is accounted for on an underwriting year basis, the amount by which the aggregate of net premiums written and other technical income exceeds net claims paid plus the increase (or less the decrease) in the net technical provisions (exclusive of any change in the credit insurance equalisation reserve) and net operating expenses;

subject in both cases to a limit of 12% of net premiums written during the financial year.

(b) If there is a technical deficit, the whole of this must (subject to the size of the provision brought forward) be transferred out.

(c) There is a maximum provision of 150% of the highest annual amount of net premiums written during the previous five financial years.

(d) There is also a de minimis limit of 4% of total net premiums written and €2,500,000. For a non-EEA insurer, the de minimis limit is calculated by reference to the UK business only.

7.9. Form 15 includes the end result of the equalisation provision calculation at line 14 for credit business and line 15 for other business. The calculation of the maximum provision and of the transfer to and from the provision is documented on Form 37, which in turn is supported by a technical account on Form 38 for accident year accounting or Form 39 for underwriting year accounting. The net transfer in or out is excluded from Form 20 and appears at line 12 of Form 16.

7.10. Forms 37 to 39 have been designed to assist insurers to follow through properly the steps described in paragraph 7.3 above. For insurance business groupings A to E, the Forms work as described in the following sub-paragraphs. Where there is reference to a particular underlying Form in the 20 series, this is to be interpreted as relating to the figures included on that Form which relate to a particular insurance business grouping. In view of the new reporting categories, it is now far less easy than previously to tie in the figures precisely to the underlying Forms, although reasonableness checks can be applied.

► Net premiums written in the current financial year (including premium adjustments relating to risks incepted in previous financial years) for each insurance business grouping are stated at line 12 of Form 37. The underlying premiums will be reported on Form 21, lines 11 to 15, columns 5 and 6 or on Form 24 line 19 column 99-99. The transfer in is stated at line 22 and represents the line 12 premiums multiplied by the factor specified in the table in paragraph 7.5 above. The total transfer in is stated in column 6.

► Any abnormal loss is calculated on Form 38 for accident year accounting or Form 39 for underwriting year accounting. Net premiums earned (Form 38) or written (Form 39) are stated at line 11 and the actual claims incurred net of reinsurance (Form 38) or claims net of reinsurance (Form 39) at line 12; the trigger claims value for

117 A pure reinsurer which became a firm in run-off before 31 December 2006 is exempt, but otherwise reinsurance business is included.
transfers out is then shown at line 13. This value represents the line 11 premiums multiplied by the trigger claims ratio specified in the table in paragraph 7.5 above which have helpfully been reproduced on the face of the Form. The abnormal loss at line 19 represents the excess of the actual net claims at line 12 over the trigger claims value at line 13; if there is no excess, line 19 is left blank. The line 19 figures are transferred to line 23 of Form 37 (aggregating accident year and underwriting year figures if necessary).

The transfer out is not necessarily the same as the abnormal loss. There are two steps to consider. Firstly, provisional transfers out are calculated at line 24; normally these will be the same as the abnormal loss for each insurance business grouping, but may need to be restricted to the maximum provision at line 13 (see (4) below). A total is shown in column 6. Secondly, the overall transfer out cannot exceed the available provision which comprises the amount brought forward plus the transfer in. Where there is an insufficient balance in the provision to fund the provisional transfers out, the excess is shown at line 25 (total column only).

The sum of lines 22 to 25 of Form 37 gives the provisional amount carried forward. However, this is constrained by the maximum provision. The maximum provision is calculated at line 13 by aggregating the net premiums written in the current financial year (line 12) with net premiums written in the previous four financial years (line 11), calculating an annual average and multiplying this by the factor shown in the table in paragraph 7.5 above. Should the maximum provision exceed the provisional amount carried forward at line 26, the excess is stated at line 27 and the final equalisation provision carried forward at line 28 represents line 26 minus line 27. It is this figure that is carried to Form 15.

The final line on Form 37 states the transfer in or out for the financial year and represents line 28 minus line 21. This figure, together with any transfer in or out for credit business, is taken to Form 16 line 12.

7.11. Accident year business claims incurred for Form 38 are derived from Form 22, lines 13 and 17, column 4. The derivation of underwriting year claims incurred for Form 39 is somewhat more complicated. Instruction 3 to the Form requires the figure to be calculated as net claims paid (Form 24.29.99-99) plus the increase in the undiscounted fund (Form 24.53.99-99 minus 24.51.99-99) subject to an adjustment to both the carried forward and brought forward fund figures to exclude claims management costs (Form 25.15.99-99) and deferred acquisition costs (Form 25.24.99-99). It may be questioned whether the rules are totally satisfactory in the case of an insurer that is applying annual accounting on an underwriting year basis. It seems somewhat paradoxical that such an insurer should be required to use written premiums as the denominator and include the movement in the unearned premium provision as part of the numerator, instead of taking an earned premium figure as the denominator as is required for business accounted for on an accident year basis. Nevertheless, INSFRU is clear as to the formula to be applied, and illogical though the approach may seem, this is what insurers are required to do.

7.12. Special rules apply to the non-credit equalisation provision where the insurer has been a party to a transfer of business under Part 7 of FSMA or by novation. If there has been a transfer out during the financial year, net written premiums in respect of the transferred business in any grouping must be deducted from total net written premiums before calculating the transfer in or the maximum provision (INSFRU 1.4.32R). In the extreme case where all business in a grouping has been transferred out, the maximum provision for that grouping is zero. If there has been a transfer in during the financial year, a sum equal to the part of the consideration that relates to business in an insurance business grouping must be:

1. excluded from net written premiums before calculating the transfer in and maximum provision
2. included in net premiums (written or earned) before calculating the abnormal loss
3. excluded from net claims (paid or incurred) before calculating the abnormal loss.

4. This last requirement is not very clearly articulated, and it may be helpful to refer to the repealed rules in IPRU(INS) that applied prior to 2004, in which it was more clearly apparent that claim portfolios received (typically treated for accounting purposes as negative claims paid, in order to cancel out the increase in claims provisions in the technical account and so be neutral as to claims incurred) were instead to be treated as premiums for the purposes of calculating whether an abnormal loss had occurred.

7.13. The credit equalisation provision is totally independent of the provision based on the five non-credit insurance business groupings. There are separate sections on Forms 37, 38 and 39 for credit business, but the methodology is very similar. The main differences from the rules referred to in paragraph 7.3 above are:

(a) the use of the technical surplus in the transfer in calculation. Consequently for credit business an insurer will have either a transfer in or a transfer out but not both in the same year;

(b) the inclusion within the calculation of the technical surplus of other technical income, claims management costs and other operating expenses, none of which feature in the abnormal loss calculation of the five insurance business groupings; and

(c) the basing of the maximum provision on the highest of the last five years rather than an average.

7.14. Equalisation provisions do not feature in the Solvency II Directive, and will therefore cease to feature as a regulatory concept once the Directive has been implemented. It is currently expected that any provision existing when the regulatory requirement ceases will be released and give rise to a tax charge systematically over a period of six years unless released earlier.
Chapter 7 – Reinsurance

This chapter deals mainly with the specific statements required to be included in the return in respect of reinsurance relating to general insurance business. The disclosures in Appendix 9.4 relating to long-term insurance business are considered separately in chapter 8. There are, however, some issues common to general and long-term insurance business which are also covered: these are to be found in paragraphs 1.8 to 1.11 (valuation and large exposures) and section 6 (insurance special purpose vehicles).

1. Introduction

1.1. The adequacy of an insurer’s reinsurance arrangements is clearly a matter to which any regulator must pay particular attention. The stability of an insurer will depend very much upon the extent to which it has taken out appropriate protection in the light of its underwriting policy, so that its net exposure resulting from any one risk or any one event is limited to a figure that can be absorbed without undue strain on solvency. It is therefore only to be expected that the return needs to contain, in addition to details of reinsurance premiums and claims by category of business, information about the reinsurance arrangements in force. The information currently prescribed is set out in Appendix 9.5 to IPRU(INS). The Appendix, which contains a list of information to be provided, but allows an insurer freedom as to the manner in which it is given, is considered in section 2 of this chapter.

1.2. It is important also that the reinsurers can be relied upon to pay in the event of a claim arising. To help the Regulator assess this, an insurer’s major treaty and facultative reinsurers must be identified in statements prescribed by rules 9.25 and 9.26 respectively. These statements are considered in section 4. The return also contains a statement of major cedants, required by rule 9.27. Although this differs from the other subject matter of this chapter in that it deals with inward rather than outward reinsurance, it will be considered in section 5 because many of the principles underlying this statement mirror those relating to the statements of major reinsurers. The rule 9.25, 9.26 and 9.27 statements are within the scope of the auditor’s report, whereas Appendix 9.5 is not.

1.3. The return reflects potential concerns relating to financial reinsurance and analogous financing arrangements in two ways. Firstly, a risk transfer principle is expressed in INSPRU 1.1.19AR, requiring that a firm can only take credit for financial reinsurance if and to the extent that there has been an effective transfer of risk from the insurer to a third party. Secondly rule 9.32A requires the inclusion of a statement (not subject to audit) providing disclosures of the effect of financial reinsurances on the return. This disclosure requirement is further considered in section 3. There is a logical tension between the two requirements, as the need to disclose an arrangement on the rule 9.32A statement would seem to imply that the risk transfer principle had not been properly followed.

1.4. One matter of general relevance to the whole of this chapter is the question of connected companies. Connection is important in two quite different senses:

1. The placing or acceptance of reinsurance by an insurer with or from another company that is connected with it.

2. The placing of reinsurance with or the acceptance of reinsurance from two or more companies that are connected with each other.

1.5. Where a type (1) connection exists it is required to be disclosed on the relevant statement. Two circumstances are specified by rule 9.28:

(a) parent, subsidiary or fellow subsidiary relationship; and

(b) control of one by the other or of both by the same person.
For the purposes of rule 9.28, a person is taken to control a company if he is a person in accordance with whose directions or instructions the directors of a company or of a company of which it is a subsidiary are accustomed to act, or who alone or with any associate or associates is entitled to exercise or control the exercise of 15% or more of the voting power at any general meeting of the company or a company of which it is a subsidiary.

1.6. Type (2) connection is important because where reinsurance is placed with or accepted from members of a group, then although a number of separate legal entities are involved, the commercial substance may be of related dealings since the failure of one group member could bring down the others. Therefore, premiums paid to or by members of groups need to be aggregated before comparison with the materiality limits. Provisions of this nature prevent the avoidance of disclosure of major reinsurers/cedants through spreading dealings around a group to keep the premiums relating to each entity below the limits. An insurer normally only needs to concern itself with parent, subsidiary or fellow-subsidiary relationships between its reinsurers or cedants. However, if the insurer is itself the parent, subsidiary or fellow subsidiary of a reinsurer or cedant then it is assumed to have better knowledge and must concern itself with parties connected with that reinsurer or cedant as a result of control. The Accounts and Statements Rules do not assume that an insurer has perfect knowledge about the connections between its reinsurers or cedants, but impose a “reasonable enquiry” test. The repealed Guidance Note 9.1 indicated that it would normally suffice for the insurer making the return to refer to the latest available published accounts or recognised industry reference documents, provided that in all cases the source to which reference is made has been published within twelve months of the end of the financial year to which the return relates.

1.7. For the purposes of the statements, Lloyd's underwriters are regarded, by virtue of IPRU(INS) rule 9.28(6), in aggregate as a single reinsurer or cedant, and any type (1) connection between a Lloyd’s member and the insurer (e.g. if a member was a controller of the insurer) need not be disclosed. It should be borne in mind that the correct disclosure on the statements is either “Lloyd’s underwriters” or “Members of Lloyd's” rather than “Lloyd’s” or “Corporation of Lloyd's”, since the insurance business is carried on by individual or corporate underwriting members at Lloyd’s and not by Lloyd’s itself. A suggestion in 2003 that the Regulator might seek disclosure syndicate by syndicate was not proceeded with.

1.8. Debts arising under a contract of reinsurance are valued on a GAAP basis by virtue of GENPRU 1.3.4R. There are no admissibility restrictions relating to reinsurance recoveries by virtue of INSPRU 2.1.34R, which states that references to a counterparty exposure do not include such an exposure resulting from debts arising from reinsurance ceded and the reinsurers’ share of technical provisions, although counterparty exposure is highlighted by the disclosures on the rule 9.25 and 9.26 statements.

1.9. Even though there are no mathematical limits on reinsurance exposures for market risk and counterparty exposure limit purposes, INSPRU does contain an evidential provision relating to reinsurance concentrations. An evidential provision, denoted by “E”, is a rule but is not binding in its own right: it always relates to some other binding rule. It is indicative of actions that tend to establish either compliance with or contravention of the underlying rule, and as such creates a rebuttable presumption. In the case of reinsurance concentrations, the underlying rule is INSPRU 2.1.8R which provides that, taking into account relevant risks, a firm must restrict to prudent levels, and adequately diversify, its exposure to counterparties. The evidential provision in INSPRU 2.1.28E indicates that in each financial year, a firm should restrict the gross earned premiums which it pays to a reinsurer or a group of closely related reinsurers to the higher of:

(a) 20% of the firm’s projected gross earned premiums for that financial year; and

(b) £4 million.

118 The 15% threshold is anomalous under the FSMA regime as the controllership threshold is 10% for PRA-authorised firms.
Compliance with this provision may be relied upon as tending to establish compliance with INSPRU 2.1.8R.

1.10. The evidential provision is not an absolute requirement, and is not intended to incentivise a wider spread of cover at the expense of quality, but places an onus on a firm to justify a higher level of cession to a particular reinsurer. INSPRU 2.1.29R requires a firm to notify the Regulator immediately it has exceeded, or anticipates exceeding, the evidential limit, and INSPRU 2.1.30R requires the firm, upon notification, to explain to the Regulator how, despite the excess reinsurance concentration, the credit risk is being safely managed. This explanation should also describe the reinsurance market in which the exposure has arisen and the nature of the reinsurance contract. Where the exposure is considered excessive, the firm should also provide a detailed plan and timetable explaining how the excess exposure will be reduced to an acceptable level. However, where a firm can demonstrate that the arrangement does not give rise to unacceptable levels of credit risk, it is unlikely that further action of this nature will be required.

1.11. Although INSPRU 2.1.20R (the requirement to manage exposures such that the firm does not place itself in a position where total default by a counterparty or for an asset class would render it unable to meet its liabilities as they fall due) does not apply to reinsurance exposures, there is a related notification requirement. An insurer is required by INSPRU 2.1.23R to notify the Regulator as soon as it becomes aware that its reinsurance exposure to a reinsurer or group of closely connected reinsurers is reasonably likely to exceed 100% of its capital resources. The notification must demonstrate that prudent provision has been made for the reinsurance exposure in excess of the 100% limit or explain why, in the opinion of the firm, no provision is required, and explain how the reinsurance exposure is being safely managed. Such a rule is logical, because if an insurer is in this position, it would become insolvent if the amounts due from the reinsurer in question could not be collected.

2. Summary of the reinsurance arrangements (rule 9.32 and Appendix 9.5)

2.1. Rule 9.32 and Appendix 9.5 to the Accounts and Statements Rules collect information about an insurer’s reinsurance arrangements. These rules were intended to allow a “free form” statement that will be easy for insurers to complete and of use to the Regulator and other users, rather than trying to force the information into a prescribed format, though in practice many insurers adopt a format similar to that which was at one time prescribed.

2.2. Most of Appendix 9.5 is concerned with non-facultative reinsurance protection. The only specific reference to facultative reinsurance comes in the final paragraph of the Appendix which calls for the amount of the reinsurers’ share of gross premiums (as shown in Forms 21 and 24) to be stated separately for each combined category (other than categories 500 and 600) and each risk category with category numbers 160, 350, 400, 510 to 590, 610 to 690 and 700. The total, for each category for which Forms 21 and 24 are prepared, will agree to Form 21 column 3 lines 11 to 15 plus column 4 lines 12 to 15 plus Form 24 line 12 column 99-99. It is common to present the information in tabular format, as in the following example:

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2.3. The basic disclosure requirements for non-facultative contracts relate to each contract entered into or modified during the financial year in question. There is no routine requirement to report contracts previously entered into under which premiums continue to be payable in accordance with the terms of the contract; the circumstances that can trigger non-routine disclosure are considered in paragraph 2.5 below. The four items to be covered by the statement for each contract are:

(a) the type of business covered by reference to risk categories, and if only part of a risk category is covered, a description of that part;

(b) the type of cover, including such details of the terms and conditions of the contract as are necessary for a proper understanding of the nature of the cover;
2.4. The information required can be provided in the form of a chart or table. Diagrammatic presentation can help to illustrate how a reinsurance programme fits together. However the information is presented, it is important to avoid minimalist disclosures, and make a genuine attempt to provide "such details as are necessary for a proper understanding".

2.5. If a contract that has been reported in the Appendix 9.5 statement is subsequently modified, information has to be given in the year of modification, but only in respect of the changes to the information previously provided in respect of (a) to (d) as set out in paragraph 2.3 above, where the information originally disclosed has been rendered either inaccurate or materially incomplete (e.g. if an arrangement has subsequently been commuted). This requirement does not apply to modifications to contracts initially entered into before the beginning of the financial year of the insurer to which the Insurance Companies (Accounts and Statements) Regulations 1996 first applied (prior to the first financial year ending on or after 23 December 1996), although completely new arrangements (e.g. a stop loss) relating to such old underwriting years would need to be reported. A contract is deemed to be modified where its original terms are altered by mutual agreement of the parties. The exercise by one party of an option (e.g. to extend cover) is not deemed to be a modification, although the repealed Guidance Note 9.1 indicated that in such cases the existence of the option should be disclosed at the outset in the "type of cover" description.

2.6. Paragraph 3 calls for three additional disclosures, where relevant, in respect of contracts reported on the statement in the present or any previous financial year.

(a) Any contract subject to no, or a limited number of, reinstatements where it is anticipated that claims which have occurred up to the end of the financial year (including IBNR for any specific occurrence for which provisions have been allocated) will exhaust the reinsurance. Reporting is only necessary in the financial year in which such exhaustion is first foreseen.

(b) The percentage of cover, if in excess of 10% and (subject to (c)) not previously reported, ceded to reinsurers which have ceased to pay claims to their reinsureds in full, whether because of insolvency or for any other reason. This may arise either where liquidation, provisional liquidation or a scheme of arrangement is in force or where a claims moratorium is being operated outside the protection of a formal insolvency procedure. The repealed Guidance Note 9.1 emphasised that the reinsurer does not need to have actually refused in such a situation to pay in full the particular insurer preparing the return for disclosure to be triggered. Conversely, situations where the reinsurer was paying the general body of its reinsureds but was not paying the particular reinsured because of a dispute would not be disclosable. The disclosure should identify the reinsurance contract and state the participation represented by reinsurers that have ceased to pay claims in full. The Guidance Note stressed that the percentage to be disclosed is the full percentage participation for a reinsurer, even if that reinsurer is still making partial payments on claims, although the rate of partial payment could be stated as an additional voluntary disclosure.

(c) If the percentage specified in (b) has increased by more than ten percentage points since the last occasion on which it was specified in the statement, the increased percentage must be stated unless, in the opinion of the directors, the likelihood of any claims being incurred under that contract is minimal. Cumulative increases of ten percentage points or less are not reportable.

2.7. Paragraph 4 requires disclosure for each risk category or part thereof in respect of which separate non-facultative reinsurance cover has been obtained, of the maximum probable...
loss (often referred to as ‘MPL’) to the insurer from, separately, any one contract of insurance, and all such contracts taken together, i.e. on both a per risk and per event basis.

2.8. The wording makes it clear that these disclosures extend to risk categories or parts thereof for which no reinsurance cover was obtained. “Maximum probable loss” is defined as the maximum loss (net of reinsurance) arising from any one incident, or any one series of incidents from the same originating cause which the directors, at the time they decided upon the reinsurance cover to be obtained in respect of the financial year in question, reasonably contemplated to be of a type which might take place during that financial year, or which has actually occurred during the financial year in question. MPL is not therefore equivalent to the maximum exposure under a contract or maximum aggregate exposure under all contracts, i.e. assuming a total loss occurs on each.

2.9. The repealed Guidance Note 9.1 indicated that the reference to “any one incident or series of incidents arising from the same originating cause” is intended to require the aggregation of losses from a single incident or series of incidents where these would have to be aggregated for the purpose of making recoveries on the insurer’s (per event or catastrophe) reinsurance. There is a single MPL on each of the prescribed bases for a given risk category or part thereof after taking account of all reinsurance protections, and it would therefore be incorrect to show a separate figure for every non-facultative reinsurance protection.

2.10. The MPL to be disclosed is the retained MPL, net of reinsurance cover, though MPL (or ‘PML’) is commonly used in the insurance industry to refer to the maximum probable loss, per risk or per event, gross of reinsurance, and clearly the MPL to be reported can be derived from this higher figure, less the reinsurance recoveries (net of reinstatements) expected to be made in the event of the insured event occurring. Care should be taken in collating and presenting the information, to avoid possibility of confusion.

2.11. The MPL should also not be confused with the deductible or retention on the insurer’s lowest level of reinsurance protection. The MPL can also be thought of as including:

(a) this deductible;

(b) the cost borne by the insurer as a result of any layer of the reinsurance protection containing a co-reinsurance clause or not being fully placed;

(c) any excess of the maximum probable gross loss over the top layer of available protection; and

(d) additional (e.g. reinstatement) premiums triggered as a result of recoveries from the reinsurance programme.

3. **Additional information on financial reinsurance and financing arrangements (rule 9.32A)**

3.1. The latter decades of the twentieth century saw the development and increasing use of so-called “financial reinsurance” contracts which occupy various points on the spectrum between what are clearly contracts of reinsurance and arrangements that might be regarded as more of a financing nature with little effective transfer of risk. Regulators have long taken interest in the potential impact of such contracts on the reliability of solvency information, because of the risk that inappropriate treatment of such contracts in the regulatory returns could present a misleading impression of the insurer’s financial position. Changes in accounting and regulation have taken place with the intention of preventing such a result. In order to comply with FRS 5, the economic substance of a reinsurance contract needs to be reflected in the result for the year and the balance sheet. The ABI SORP indicates that the following considerations are critical in determining the economic substance of a contract.

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119 There is an equivalent concept in IFRS, achieved through the definition of ‘insurance contract’ in IFRS 4, which requires the presence of significant insurance risk.
(a) A key characteristic of reinsurance is the transfer and assumption of significant insurance risk. There will be no transfer of insurance risk where the contract provides for the reinsurer to receive no more than a lender’s rate of return under all reasonably possible scenarios.

(b) The insurance risks relating to a general reinsurance contract may consist of either or both of underwriting risk and timing risk.

(c) In considering whether a significant transfer of insurance risk has taken place, the entity should consider first whether it is reasonably possible that the reinsurer may realise a significant loss from the contract and secondly whether there is reasonable possibility of a significant range of outcomes from the contract. Insurance risk will not have transferred unless both of these conditions are satisfied. ‘Significant’ should be assessed in the context of the commercial substance of the contract or contracts being evaluated as a whole, and should be judged with reference to the range of outcomes that would reasonably be expected to occur in practice.

(d) The assessment as to whether or not significant insurance risk is transferred should be made prospectively at the time the contract is entered into. The method of accounting should be followed consistently over the whole period of the contract. If there has been a material change in contract terms during the period of the contract, the entity should perform a new assessment of whether or not a significant transfer of insurance risk has occurred.

(e) Any reinsurance contract should be accounted for in two parts where elements can be identified that do not result in the transfer of significant insurance risk.

3.2. Paragraph 26 of Appendix 9.2 specifically requires amounts in respect of inwards and outwards contracts of insurance to be classified for inclusion in Forms 20 to 39 according to their economic substance in accordance with generally accepted accounting practice (which the ABI SORP serves to define for Companies Act purposes). If this leads to amounts in respect of an inward or outward contract of insurance being excluded from the revenue account a supplementary note (code 20Ak) is required to provide:

(a) a description of the terms of that contract;

(b) a description of the accounting treatment adopted and an explanation for adopting that treatment;

(c) a statement of the amounts paid and received during the financial year under that contract; and

(d) a statement of the amounts in respect of that contract included in each Form prepared under Appendix 9.1 and Appendix 9.2.

3.3. As will be appreciated, the above disclosure is extensive. An insurer may elect to show the required information in respect of groups of contracts which were effected in the same financial year with substantially the same contract terms and in respect of which the same accounting treatment has been adopted. As indicated in chapter 3, such contracts still have to be treated as insurance business for the purposes of Forms 11 and 12, and differences between these and the revenue Forms explained in supplementary notes. Some financial reinsurances may be captured by paragraph 28 of Appendix 9.2 which requires disclosure in supplementary note 2206 or 2503 of reinsurance recoveries not expected to be received until more than 12 months after payment of the underlying gross claims.

3.4. In addition to these requirements, rule 9.32A and associated guidance material 9.32B were introduced with the intention of requiring general insurers to disclose in the return the existence of, and relevant information about, financial reinsurance agreements and transactions for business ceded where the credit taken in the regulatory return for these transactions is not commensurate with the economic value added after taking account of the
level of risk transferred, or where there are terms that have the potential to render the reinsurance agreement ineffective or to affect materially its value. As suggested in paragraph 1.3 above, if any contract does fall for disclosure as having these characteristics, the insurer should consider why this is, and whether the arrangement in question was correctly dealt with in the first place.

3.5. The disclosures required by the rule 9.32A statement relate both to financial reinsurances ceded and to financing arrangements (assumed financial reinsurance is not within scope, as the Regulator did not consider when introducing these provisions that there was evidence that this was giving rise to material distortion of the reported financial position of the accepting company). A ceded financial reinsurance or similar arrangement is disclosable if, subject to de minimis limits:

(a) the value placed on future payments in respect of the contract in the return is not commensurate with the economic value provided by that contract, after taking into account the level of risk transferred, or

(b) there are terms or foreseeable contingencies (other than the insured event) that have the potential to affect materially the value placed on the contract in the insurer’s balance sheet at, or any time after, the end of the financial year.

3.6. Where such an arrangement exists, it is necessary to disclose, subject to the de minimis provisions considered in paragraph 3.13 below:

(a) the financial year in which the contract was first reported in the return;

(b) the financial effect of the contract on the insurer’s capital resources at Form 1 line 13 in the present return;

(c) the amount of any undischarged obligation of the insurer under the contract and a brief description of the conditions for the discharge of such obligations; and

(d) how any undischarged obligations, including any contingent obligations, have been taken into account in determining the insurer’s capital resources.

3.7. It seems strange that the prescribed disclosures do not also extend to the effect of the contract on the insurer’s capital resources requirement, given that this is determined based on the legal form of the contracts rather than their economic substance. Some, if not all, of the necessary information may be deduced from the disclosures made under supplementary note 20Ak (paragraph 3.2(d) above).

3.8. It is also necessary to provide a general description of how the insurer makes the financial assessment that enables it to determine whether a contract meets the criteria triggering disclosure, even if the outcome of that assessment is that no contracts need to be reported in the statement. This requirement would appear to necessitate the inclusion of a rule 9.32A statement in the return of every general insurer. Even an insurer with no outward reinsurance arrangements would need to say how it was satisfied that no financing arrangement triggered the disclosure requirement.

3.9. It is also necessary to disclose information about financing arrangements, which largely mirrors the information that life insurers are required to provide in paragraph 9 of Appendix 9.4 (see chapter 8, paragraph 5.11). Disclosure is triggered where a contract, other than a contract of (re)insurance, has been entered into by the insurer in respect of contracts of insurance written by the insurer which has the effect of increasing the insurer’s capital resources at Form 1 line 13 and which includes terms for:

(a) the transfer of assets to the insurer, the creation of a debt to the insurer or the transfer from the insurer to another party of liabilities to policyholders (or any combination thereof); or
(b) either an obligation for the insurer to return (with or without interest) some or all of such assets, a provision for the diminution of such debt or a provision for the recapture of such liabilities, in each case, in specified circumstances.

3.10. Where such a contract exists, the prescribed disclosures are equivalent to those for a disclosable financial reinsurance arrangement set out in the previous paragraph.

3.11. The Regulator has adopted a principles-based approach to defining the arrangements to be disclosed. Rule 9.32A(3) and (5) apply logical anti-avoidance provisions by requiring the insurer to:

(a) treat as part of a contract any agreements, correspondence (including side letters) or understandings that amend or modify, or purport to amend or modify, the contract or its operations; and

(b) consider whether the contract meets the disclosure criteria when considered in conjunction with one or more other contracts entered into between the insurer and the reinsurer/counterparty under the first contract, or between the insurer and any other person where it could reasonably have been predicted, at the time the first contract was entered into, that the contracts when considered together would meet the disclosure criteria.

3.12. Guidance in 9.32B indicates that the disclosure criteria are likely to be satisfied where there are features in the contract which have the effect of materially limiting the difference between the extent of the indemnity cover provided by the contract and any related, or potentially related, contracts, and the premiums payable under those contracts. 9.32B goes on to indicate particular features encountered in contracts in the past which while not constituting an exhaustive list of indicators may be of relevance to the assessment, including:

(a) sliding scale fees, retrospectively rated premiums and profit sharing formulae;

(b) provision for an experience account;

(c) provision for termination at the sole discretion of the reinsurer when there is a positive balance due from the reinsurer; and

(d) inclusion of a term requiring the insurer to enter into a further contract if the loss experience attains a certain level.

3.13. Disclosure is not required where the effect of the arrangements on the capital resources is not material. The threshold has been set at an impact on capital resources which is less than 1% of gross technical provisions in the return and which is expected to remain less than 1% for the foreseeable future. All contracts with a given reinsurer or counterparty need to be considered in the aggregate.


4.1. Rules 9.25 and 9.26 require presentation as part of the return of, respectively, a statement of major treaty reinsurers and a statement of major facultative reinsurers. The work involved in the completion of the statements of major reinsurers can be broken down into steps, which need to be performed separately for the two statements and which should be tackled in the following order:

(a) Compute the materiality limits for premiums and counterparty exposure;

(b) Compare the premium limit with premiums payable in the financial year to a reinsurer or group of connected reinsurers and the counterparty exposure limit with debts plus the reinsurer’s share of the outstanding claims provision;
(c) List the full names of reinsurers identified, their connected companies and reinsurers disclosed in previous years that remain reportable;

(d) Disclose the remaining prescribed details for all reinsurers identified.

4.2. For treaty business, rule 9.25(2)(a) defines separate premium materiality limits – amounts which if exceeded will lead to a company being classified as a major reinsurer – for proportional reinsurance (quota share and surplus treaties) and non-proportional reinsurance (excess of loss and stop loss). The definitions are as follows:

- proportional reinsurance – 2% of the gross premiums receivable by the insurer in respect of general insurance business
- non-proportional reinsurance – 5% of the total premiums payable by the insurer in respect of all such reinsurance.

4.3. The proportional reinsurance limit will normally represent 2% of the figure appearing at Form 11.11.1, but the non-proportional limit will need to be arrived at by aggregating non-proportional treaty premiums payable. These limits differ in character, since whereas the former is defined by reference to the whole of the business of an insurer, the latter is dependent upon how widely the non-proportional reinsurance protection taken out by an insurer has been spread. Even if the excess of loss premiums paid by an insurer come to only £1,000, any reinsurer taking 5% or more (i.e. £50) will be deemed to be major. It is important to follow the definitions strictly and not fall into the common trap of basing the non-proportional limit on reinsurance premiums payable in respect of non-proportional treaty business accepted. What matters in this case is how the business is ceded and not how it is accepted. Rule 9.25 also provides an additional materiality criterion, whereby a reinsurer is major if debts due from that reinsurer included at line 75 of Form 13, together with that reinsurer’s share of technical provisions in respect of claims outstanding included at line 61 of Form 13, exceed the sum of €20,000 and 5% of the insurer’s liabilities arising from its general insurance business, net of reinsurance ceded.

4.4. The second stage in the process is to compare the two premium materiality limits with proportional treaty premiums paid and non-proportional treaty premiums paid to particular reinsurers. Any company exceeding either is a major reinsurer. This comparison may be more easily said than done, since it will be necessary to aggregate the premiums payable under different treaties, and automatic capture of such information through the systems is clearly likely to be a considerable time saver in this area. A complication arises from the fact that where there is a type (2) connection between reinsurers, the premiums payable to connected parties must be aggregated for comparison with the materiality limits. Again some appropriate computer coding may be the best way of tackling this difficulty. If this is not possible, one practical approach is to flag all reinsurers that exceed a specified percentage (say 25%) of the materiality limit and then investigate payments to companies connected with all those so flagged. The exposure yardstick figure will need to be compared with the figures at lines 61 and 75 of Form 13, again aggregating reinsurers with a type (2) connection.

4.5. For facultative reinsurance, materiality needs to be assessed in the context of a major facultative reinsurance contract; in other words there is no need to aggregate amounts payable to a reinsurer under different facultative reinsurance contracts. The premium materiality limit is 0.5% of gross premiums receivable in respect of general insurance business; there is no need to aggregate premiums payable to connected reinsurers for comparison with this limit. There is a materiality limit based on counterparty exposure of the sum of €4,000 and 1% of the insurer’s liabilities arising from general insurance business, net of reinsurance ceded.

120 It will be recalled from paragraph 1.4 of this chapter that a type (1) connection represents the placing or acceptance of reinsurance by an insurer with or from another company that is connected with it, and a type (2) connection the placing of reinsurance with or the acceptance of reinsurance from two or more companies that are connected with each other.
4.6. After this exercise has been completed, a list will have been derived of all reinsurers individually in excess of the materiality limit, together (in the case of rule 9.25) with groups where the combined premiums or counterparty exposure exceed the limits. The companies to be reported on the statement will comprise the following:

(a) individual reinsurers in excess of one of the limits;
(b) any companies connected with the reinsurers identified in a to which any premiums of the relevant type were paid in the financial year;
(c) all members of groups to which aggregate treaty premiums in excess of one of the limits were paid in the financial year, or which exceed the counterparty exposure limit; and
(d) in the case of rule 9.25, any reinsurer not covered by (a), (b) or (c) which appeared on the statement in the return for the previous financial year, unless it has not exceeded, or been part of a group which exceeded, the materiality limit for any of the last five financial years.

4.7. Where disclosures arise by virtue of (b) and (c), separate details needs to be given for each company. The “full name” to be stated means the corporate name of a body corporate or the name under which an individual or unincorporated body lawfully carries on business.

4.8. With the major reinsurers now identified, the remaining prescribed details to be given for each reinsurer are as follows:

(a) the address of the registered office or of the principal office in the country of incorporation (or, in the case of an unincorporated body, of the principal office) of the reinsurer
(b) whether (and, if so, how) the insurer was at any time in the financial year connected with the reinsurer (i.e. type (1) connection)
(c) the amount of reinsurance premiums payable in the financial year - for rule 9.25 this has to be stated separately in respect of both proportional and non-proportional treaties even if only one of the materiality limits has been exceeded
(d) any debt at the end of the financial year included at line 75 of Form 13
(e) any deposit received from the reinsurer included at line 31 of Form 15
(f) anticipated recoveries taken into account in determining the reinsurer’s share of technical provisions in respect of claims outstanding included at line 61 of Form 13.

4.9. Figures must be rounded to the nearer £000 (rule 9.28(5)(c)). In the case of (f), recoveries relating to IBNR claims need only be included to the extent that they are in respect of any specific occurrences for which provisions have been allocated by the insurer.

4.10. A particular point to watch arises where more than one party is accepting business on an insurer’s behalf – as an example the case of the UK branch return of an external direct insurer with three UK underwriting agents will be considered. The return such an insurer has to make deals with the UK branch operations as a whole. Although for much of the return it is satisfactory to carry out a straightforward consolidation of information supplied by each of the agents, this does not work in the case of the rule 9.25 statement for two main reasons:

► A reinsurer appearing to be major in the context of one agent may not be so when premiums payable are compared with the branch materiality limits.
A reinsurer who is major in terms of one agent and the branch as a whole, may receive premiums from the other agents which fail to be notified for aggregation because the reinsurer is below the agency materiality limits.

4.11. To overcome these difficulties, the compilation of the statement has to be tackled in stages:

1. Each agent should prepare a list of the names and addresses of all companies which would represent major reinsurers based purely on the figures for the agency in respect of the financial year. It will be readily appreciated that an insurer cannot exceed the materiality limit for the branch as a whole unless it does so in respect of at least one of the agents.

2. The insurer should compile a list of the reinsurers identified by any of the agents together with any other reinsurers which have to be reported by virtue of their having appeared on the statement in previous financial years.

3. Each agent should be given the list and asked to note beside each name the proportional and non-proportional treaty premiums payable in the financial year and the prescribed year end disclosures. In addition the agent should be asked to add to the list the relevant details for any companies connected to those appearing thereon to which premiums have been paid in the financial year.

4. The insurer can now accumulate data from the agency replies and compare proportional and non-proportional premiums for each reinsurer or group with the respective branch materiality limits. Preparation of the statement will proceed in the normal way.

4.12. This procedure may be modified if one of the agents accounts for the bulk of the branch’s activities. In this case the statement could be drafted on the basis of the main agent, and the other agents simply circularised to ascertain whether they have any premiums or year end items to report in relation to the ascertained major reinsurers.

5. Statement of major cedants (rule 9.27)

5.1. Rule 9.27 requires presentation of a statement of major cedants. The steps involved in the preparation of this statement are very similar to those discussed in the previous section in relation to the statement of major treaty reinsurers. This section will therefore identify the differences in procedure that need to be observed under rule 9.27.

5.2. There is no counterparty exposure limit and no distinction between proportional and non-proportional treaty reinsurance is made under rule 9.27. Consequently there is only one materiality limit. This is calculated as the higher of two figures:

(a) 5% of gross premiums receivable in respect of general insurance business treaty reinsurance (which can be derived directly as 5% x Form 20A line 3 column 1); and

(b) 2% of gross premiums receivable in respect of general insurance business (normally 2% x 11.11.1, which is also the proportional treaty limit for the purposes of rule 9.25).

(b) will give a higher result than (a) if more than 60% of an insurer’s premiums derive from direct and facultative business. The point of this is to avoid disclosure of cedants who, while important in terms of their share of treaty premiums, are immaterial in terms of the insurer’s business as a whole.

5.3. Having arrived at the materiality limit the comparison with treaty premiums receivable and the considerations relating to type (2) connections are no different from rule 9.25 (paragraph 4.6 above). The only slight variation in arriving at the names to include on the statement, is that an insurer which appeared on the previous year’s statement need not reappear this year.
if it has not exceeded the materiality limit in the present or previous three (rather than five) financial years.

5.4. Of the particulars to be disclosed on the statement, full name, address and details of connection (if any) are the same as for rule 9.25. Treaty premiums receivable form an obvious substitution for treaty premiums payable. The year end balances with the cedant to be disclosed are the amount of any deposit included at line 57 of Form 13 and the amount of any debt due from the cedant included at line 74 of Form 13.

6. **Insurance special purpose vehicles**

6.1. An insurance special purpose vehicle (“ISPV”) is a vehicle for achieving an insurance securitisation. The Reinsurance Directive provided EEA States that wanted to encourage the development of a market for ISPVs in their jurisdiction with an option to introduce a separate fit-for-purpose authorisation and supervisory regime, covering authorisation and solvency requirements, when amounts due from an ISPV can be counted as admissible assets and when amounts due from an ISPV can be counted as reinsurance or retrocession in order to reduce the ceding insurer’s solvency requirements. The UK exercised this option and the rules relating to ISPVs are set out in INSPRU 1.6.

6.2. The Handbook glossary definition of an ISPV is:

“an undertaking, other than an insurance undertaking or a reinsurance undertaking which has received an official authorisation in accordance with article 6 of the First Non-Life Directive, article 4 of the Consolidated Life Directive or article 3 of the Reinsurance Directive:

► which assumes risks from such insurance undertakings or reinsurance undertakings

► which fully funds its exposure to such risks through the proceeds of a debt issuance or some other financing mechanism where the repayment rights of the providers of such debt or other financing mechanism are subordinated to the undertaking’s reinsurance obligations.121

6.3. INSPRU 1.6.3G states that to be considered fully funded an ISPV must have actually received the proceeds of the debt issuance or other mechanism by which it is financed. Financing cannot be on a contingent basis, for example, a standby facility or letter of credit. The Regulator also requires, so that the ISPV remains at all times fully funded, that the ISPV’s reinsurance liabilities are capped at the value of the assets available to cover those liabilities (with assets determined under the prudent person investment principles described in chapter 4).

6.4. It would be outside the scope of this publication to describe the simplified authorisation regime that will apply to an ISPV. The key point for the ongoing supervision of an ISPV is that the Handbook glossary definition of “insurer” specifically excludes UK ISPVs. As a result the whole of IPRU(INS) does not apply, and there is no need for a UK ISPV to submit a PRA return. Specific prudential requirements for ISPVs appear in INSIPRU 1.6. Under INSIPRU 1.6.5R, an ISPV is required to ensure that at all times its assets are greater than or equal to its liabilities. As the ISPV’s liabilities are required to be limited to its assets, no solvency requirement has been established. Any residual risk is retained by the ceding firm as evidenced by its ICA.

6.5. Amounts recoverable from ISPVs are excluded by GENPRU 2 Annex 7R from the list of admissible assets, by INSIPRU 1.1.92AR from the calculation of the reinsurance ratio, the insurance death risk capital component and the adjusted mathematical reserves and by INSIPRU 1.2.28AR from the calculation of mathematical reserves. If credit is to be taken for

121 The definition is problematic as it suggests that an entity cannot be an ISPV unless at least one of its cedants is authorised under one of the specified Articles, but this would have the effect of excluding an entity for which the only cedant was the UK branch of a non-EEA direct insurer. It is also not clear from the definition, though it is apparent from the rules in the Handbook, that the only risks that an ISPV may assume from insurance and reinsurance undertakings are reinsurance ones.
such items, it is necessary to obtain a waiver. Guidance in INS PRU 1.6 indicates that in addition to the statutory tests for a waiver, the Regulator will need to be satisfied about the following matters:

- If the ISPV is a UK ISPV, that it complies with INS PRU 1.6.5R to INS PRU 1.6.12R.

- If the ISPV is not a UK ISPV, that it has received an official authorisation under article 46 of the Reinsurance Directive in the EEA State in which it is established. The Regulator will also need details of the debt issuance or other funding mechanism by which the ISPV's liabilities are to be funded, information about the ISPV's management and control functions and information about the structure of any group of which the ISPV is a member.

- That the contract will meet the risk transfer principle set out in INS PRU 1.1.19AR.

- The impact of the ISPV arrangement on the ceding insurer’s ICA (including evidence that all residual risks associated with the arrangement have been taken into account).

- The Regulator will also expect to receive an analysis of the potential for risk to revert to the ceding insurer or any of its associates under realistic adverse scenarios, or for liabilities to arise in respect of the risks transferred for which no provision has been made.

6.6. This description of conditions for a waiver is silent so far as concerns an ISPV established outside the EEA, though the Regulator did indicate (in feedback in CP 06/16) that it would require waivers before allowing recognition of recoveries from such entities. It should be noted that the Directive definition of ‘special purpose vehicle’ would not extend to entities outside the EEA, so the Regulator’s approach of requiring a waiver for any such entity does not derive from the Directive. Any amounts included at Form 13 lines 60 to 62 recoverable from an ISPV where a waiver has been obtained are required to be disclosed in a supplementary note (code 1320).

6.7. Although an ISPV is not an “insurer”, it does represent an “insurance undertaking” and can therefore represent a “regulated related undertaking” which must be taken into account in group capital adequacy calculations including the adjusted solo calculation of an insurer (see chapter 10). One possible consequence of including in the calculations both an ISPV and a related insurer that cedes business to it is that the insurer could be denied capital credit for the recovery due from the ISPV if no waiver is given, while the liability in the ISPV would still need to be recognised as a reduction in capital resources.

6.8. Some issues arise from the fact that ISPVs are not subject to the special definitions of capital or the valuation rules that apply to insurers. An ISPV is required under INS PRU 1.6.5R to ensure that at all times its assets are greater than or equal to its liabilities. One common objective of an ISPV would be to secure funding for insurance risks by way of instruments other than ordinary share capital (as reflected in the Handbook definition of ISPV quoted above). However, instruments such as subordinated debt and some preference shares are classified for GAAP purposes as liabilities rather than capital, raising immediate questions of solvency as soon as a reinsured event occurs. To overcome this problem, an ISPV funded by debt or preference shares rather than ordinary shares would need to obtain a waiver to modify the strict solvency requirement by reclassifying its funding instruments as capital so as to absorb its losses. Given that the cedant already requires a waiver in order to be able to recognise recoveries from an ISPV, it seems excessive to require the ISPV to obtain a separate waiver as well.

\[122\] The Handbook definition of this term is broader than the definition in the European Directives, which is limited to undertakings with authorisation under the direct insurance Directives and having their head offices in EEA member States.
Chapter 8 – Long-term insurance business

This chapter considers the parts of the return specific to long-term insurance business - namely Appendices 9.3, 9.4 and 9.4A and the rule 9.36 statement of information on the actuary appointed to perform the with-profits actuary function. Whilst the auditor can no longer rely on the appointed actuary’s certificate for the mathematical reserves and required minimum margin for long-term insurance business, as was at one time the case, some of the Forms described in sections 2 and 4 remain outside the scope of the audit (see paragraph 2.4 of chapter 9 for details).

This chapter has six sections; section 1 of this chapter deals with revenue account presentation, section 2 linked business, section 3 the role and responsibilities of the actuaries, section 4 the remaining Forms for long-term insurance, section 5 the actuarial abstract and section 6 realistic reporting.

1. Revenue account presentation (Forms 16 and 40 to 43)

1.1. The revenue account Forms prescribed by Appendix 9.3 (this Appendix also prescribes a certain amount of balance sheet information e.g. the Form 44 balance sheet for internal linked funds) differ from the corresponding Appendix 9.2 Forms for general insurance business in a significant respects. Appendix 9.3 requires a revenue account based on fund accounting (as was at one time traditional) rather than a technical account as prescribed by the insurance accounts rules.

1.2. As for general insurance business there is a distinction between figures reported in the non-technical account (Form 16) and revenue account (Form 40), but where an insurer carries on long-term insurance business it does not have the same freedom in deciding where to include certain items. The reason for this stems from INSPRU 1.5 which contains the following provisions.

(a) The assets required to be held by virtue of INSPRU 1.1.20R (admissible assets must be held to a value at least equal to the technical provisions) and INSPRU 1.1.21R (a composite firm must ensure that its identified long-term insurance assets are at least equal to the amount of its technical provisions for long-term insurance liabilities and any other liabilities connected with long-term insurance business) are required to be identified (INSPRU 1.5.18R).

(b) Long-term insurance assets are:

(i). the assets identified under INSPRU 1.5.18R (including assets into which those assets have been converted);

(ii). any other assets identified by the firm as available to cover its long-term insurance liabilities;

(iii). premiums and other receivables in respect of long-term insurance business;

(iv). other receipts of the long-term insurance business; and

(v). all income and capital receipts in respect of the above; less

(vi). outgo in respect of the long-term insurance business and any transfers made under INSPRU 1.5.27R (INSPRU 1.5.21R).

(c) All the long-term insurance assets of the firm constitute the long-term insurance fund unless the firm identifies particular long-term insurance assets in connection with different parts of its long-term insurance business, in which case the assets identified in respect of each such part constitute separate long-term insurance funds of the firm.
There is no longer a requirement to have a separate fund for industrial business.

Separate accounting records must be maintained in respect of each long-term insurance fund (including each with-profits fund).

1.3. Following on from these requirements, INSPRU 1.5.27R provides that a firm must not transfer assets out of a long-term insurance fund unless the assets represent an established surplus and not more than three months have elapsed since the determination of that surplus. This rule does not prohibit exchanges of long-term insurance assets and other than long-term insurance assets at fair market value. The assets representing the long-term insurance business fund are only applicable for the purposes of that business (INSPRU 1.5.30R), and an insurer must not agree to, or allow, any mortgage or charge on its long-term insurance assets other than in respect of a long-term insurance liability. In view of these requirements, it is clear that all items of income and expenditure (including taxation) relating to long-term insurance business must appear on Form 40. For a life insurer that is not a composite, Form 16 will only show, apart from any transfer into or out of the fund at line 13, items of income and expenditure attributable to the shareholders’ assets and liabilities. An insurer may choose to allocate investment income on its shareholder assets to the policyholders. Where this is the case, the correct treatment is to show the income and any related management expenses on Form 16, with a transfer from Form 16 line 13 to Form 40 line 26. Instruction 3 to Form 40 requires the amount in question to be shown as a supplementary note (code 4003).

1.4. One of the features of accounts prepared in accordance with IFRS is that the definition of an “insurance contract” means that some contracts which have the legal form of insurance contracts may fall to be treated as investment contracts. Paragraph 8 of Appendix 9.3 requires the full amount of premiums and claims under a long-term insurance contract to be reported at the relevant lines, and forbids a deposit accounting approach on Forms 40 to 60, even if the insurer or the group to which it belongs uses this basis in accordance with IFRS.

1.5. The preparation of separate Forms for different categories of general insurance business encountered in chapter 6 does not apply to long-term insurance business. Although as will be seen more than one set of revenue account Forms may need to be prepared, the division is by reference to the separate funds which an insurer maintains rather than to prescribed classes of business. However, a formal division does need to be reported on the face of Forms 41, 42 and 43, according a three way split into UK life, UK pensions and overseas. These types of business are defined as follows:

(a) “overseas business” means long-term insurance business which is Overseas Life Assurance Business or Overseas PHI and Sickness Business as defined by the Income & Corporation Taxes Act 1988 or business written overseas by an insurer which does not report its Overseas Life Assurance Business separately for tax purposes;

(b) “UK pension business” means long-term insurance business which is Pensions Business as defined by the Income & Corporation Taxes Act 1988; and

(c) “UK life business” means long-term insurance business which is not overseas business or UK pensions business (i.e. this is the sweep-up category).

1.6. Paragraph 8 of Appendix 9.3 provides that where neither the mathematical reserves nor the gross premiums for overseas business exceeds £50 million or 5% of the gross mathematical reserves, an insurer can treat as UK pensions business any element which would fall within that definition if it were business effected in the United Kingdom, and can classify the balance of the overseas business as UK life business.

1.7. Form 40, which represents the basic revenue account, is the long-term insurance business equivalent to Form 20 for general insurance business. Summary Forms 40 to 43 are required where there is more than one fund, and can be thought of as equivalent to the category 001
Forms prepared for general insurance business. As was the case with various Forms within Appendix 9.2, a supplementary note (code 4001) is required where there are differences between the fund brought forward on Form 40 and the corresponding carried forward fund in the previous return.

1.8. Separate Forms 40 to 43 are required for each long-term insurance business fund maintained by the insurer (rules 9.14(b)(i)(A) and 9.23). It is also necessary by virtue of rule 9.14(b)(i)(B) to prepare these Forms for any with-profits fund that does not represent a long-term insurance business fund in its own right: in this case a supplementary note (code 4010) is required to state the amount, if any, of investment income in respect of linked assets included at line 12. As is the case for Form 14, the funds are identified by narrative in the heading: code numbers are used only on Form 13. Any insurer that does maintain more than one long-term insurance business fund must provide a supplementary note to Form 40 (code 4006) giving the principles and methods applied to apportioning the investment income, increase or decrease in the value of assets brought into account, expenses and taxation between the different funds.

1.9. Form 40 shows, broadly speaking, items of income at lines 11 to 19, items of expenditure at lines 21 to 29, business transfers in and out at lines 41 and 42 and fund movements at lines 39 to 59. It is similar to the summary general insurance business technical account (Form 20), in that the figures are stated net of reinsurance but differs in that its bottom line represents not an underwriting result but the fund carried forward. This is the logical outcome of the statutory method of accounting, since the transfer to (or from) the non-technical account at line 26 is not so much the accounting profit or loss for the year as that proportion of the actuarially determined surplus which the directors have decided to allocate to the shareholders or the amount of any deficit (e.g. that resulting from new business strain in a start up situation) which has to be made good from shareholders’ funds. For the total Form, the fund carried forward will agree to Form 14 line 14 and the transfer to or from the non-technical account to Form 16 line 13.

1.10. Lines 31 and 32 deal respectively with business transfers in and out, and include transfers of contracts from and to other funds as well as transfers from and to other insurers. Details are required to be specified in a supplementary note (code 4004).

1.11. Paragraph 14.1(9) of the repealed Guidance Note 9.1 provided a table that sought to relate Form 40 to the Schedule 3 long-term insurance technical account and identify the major points of difference in the accounting treatment. The table achieved what it set out to do as well as seemed possible, but it was an uphill struggle since the underlying bases are so different, and the present publication will not attempt to re-perform the exercise. However, the table did include a number of valuable insights, which are drawn on in the following summary of points to watch in the completion of Form 40.

- Premiums at line 11 will always be gross of commission (a component of expenses payable at line 22) and will include income tax (now exclusively on pension policies, following the abolition of Life Assurance Premium Relief) deducted at source and recoverable from HM Revenue & Customs. Although the description of the line is “earned premiums”, Instruction 10 indicates that it excludes any change in the provision for unearned premiums, so the figure actually represents premiums receivable.

- Lines 13 and 14 deal with increases or decreases in the value of assets brought into account (non-linked and linked respectively). The repealed Guidance Note 9.1 made it clear that these lines do not only deal with unrealised gains and losses but also include realised gains and losses, which are therefore to be excluded from line 12. Line 13 should also include transfers from investment reserve and the impact of changes to asset values on the category 10 Form 13 (e.g. the effects of a change in the amount of inadmissible assets or impact of the market risk and counterparty limits). However, there is one very major caveat. Whereas the Schedule 3 technical account will include all realised and unrealised gains and losses, such gains and losses are only required to be taken to Form 40 in the case of linked business. For
non-linked business, an insurer retains discretion as to when to bring gains into account on Form 40. It can still choose to take gains for the purposes of the return to what would traditionally be referred to as an investment reserve, that will be reflected at line 51 of Form 14, and only release these to line 13 of Form 40 as and when they are needed to fund bonuses.

► If an entry is made at line 15 (other income) or line 25 (other expenditure), Instruction 2 to Form 40 requires the particulars to be specified in a supplementary note (code 4002).

► Claims incurred at line 21 only reflect movements in outstanding claims to the extent that these are provided for outside the mathematical reserves (i.e. because they have fallen due at the valuation date). Claims management expenses are excluded and fall to be dealt with under expenses payable at line 22; this is a difference from the Schedule 3 technical account where such costs form part of the disclosed claims figures.

► Expenses payable will include acquisition expenses arising during the year, but will not adjust these for the movement in deferred acquisition costs that will be included in the Schedule 3 technical account. Deferred acquisition costs are an inadmissible asset in relation to long-term insurance business.

► Line 26 only reflects transfers between policyholders’ funds and the shareholders’ fund as shown on Form 58 line 33 or 47 (see section 4 of this chapter). Inter-fund transfers, which will net down to zero, will now be included at lines 31 and 32.

1.12. Where arrangements have been made for the provision of management services to an insurer carrying on long-term insurance business by another company (whether an insurer or not), the insurer receiving the services must provide, as a supplementary note to Form 40 (code 4008), a statement to the effect that the arrangements have been in force during the financial year and naming the parties to them. Similar requirements are imposed on the company providing the services if it is an authorised insurer. The repealed Guidance Note 9.1 indicated that such a note is only needed when a substantial part of the day-to-day administration of an insurer was undertaken by another company. A disclosure of this nature is designed primarily to put the Regulator on notice of situations where services are provided by one company in a group to another for a charge that does not represent the true cost of running the company. Quite apart from its relevance to the return, any arrangement for the provision of management services may have VAT implications on which the companies concerned will need to obtain professional advice.

1.13. Form 41 provides an analysis of premiums shown at line 11 of Form 40. It has columns for UK life (1), UK pension (2) and Overseas (3) aggregating to the total column (4), and a comparative total column (5). The vertical analysis includes a gross/reinsurance/net split, a split of premiums into regular and single and an analysis of reinsurance ceded into external and intra-group. There is no separate identification on the Form of treaty reinsurance accepted. Paragraph 3 of Appendix 9.3 provides that:

► “regular premiums” means premiums under contracts of insurance which are payable at regular intervals during the policy year, including repeated or recurring single premiums where the level of premium is defined.

► “single premiums” means premiums under contracts of insurance where there is no expectation of continuing premiums being paid at regular intervals, additional single premiums paid in respect of existing individual contracts and National Insurance Rebates received from the Department of Work and Pensions.

This split is also of relevance for Forms 46 and 47 (dealt with in section 4 below). Both regular and single premiums must include that part of the premium that is or will be recoverable from HM Revenue & Customs (Instruction 1 to Form 41).
1.14. The split of reinsurance ceded into external and intra-group is intended to facilitate analysis of the more complex groups of insurance firms. In cases where there is significant intra-group reinsurance the split not just of premiums on Form 41 but elsewhere in Appendix 9.3 of recoveries, expenses, new business and in-force business is needed to allow the Regulator to calculate group ratios. It will also enable the Regulator and external users to identify risks from intra-group reinsurance.

1.15. Form 42, which provides an analysis of claims incurred shown at line 21 of Form 40, has the same five columns as Form 41 and the same basic vertical structure of gross, external reinsurance, intra-group reinsurance and net. Each vertical section has five subdivisions:

(a) death or disability lump sums
(b) disability periodic payments
(c) surrender or partial surrender
(d) annuity payments
(e) lump sums on maturity

1.16. Instruction 1 to Form 42 provides that industrial assurance claims incurred on survival in respect of periodic endowment benefits are to be classified as surrender or partial surrender and included at line 13. Instruction 2 indicates that maturity payments are restricted to payments to policyholders. Amounts paid to another insurer are included in surrender or partial surrender.

1.17. Form 43 provides an analysis of expenses at line 49 of Form 41. The Form has the same five columns as Forms 41 and 42, and again features the basic vertical split into gross, external reinsurance, intra-group reinsurance and net. The vertical subdivisions are into:

(a) commission - acquisition
(b) commission - other
(c) management - acquisition
(d) management - maintenance
(e) management - other.

1.18. The subdivision of commission into “acquisition” and “other” is reasonably obvious. For management expenses, the basis on which the three-way subdivision is to be effected is prescribed by Instruction 1 to the Form:

- Costs of a non-recurring nature, such as those incurred in developing new systems, new premises or the costs of corporate restructuring, will be classified as “other” unless they do not exceed 2% of the total management expenses, in which case they may be included as “acquisition” or “maintenance”.
- Costs incurred in writing new business (or in obtaining incremental (but not indexed) premiums on new business) such as underwriting, policy issue, setting up (or amending) records and the maintenance and developing of the sales and marketing organisation must be classified as “acquisition”.
- “Maintenance” is in effect the balancing item, relating to the ongoing costs throughout the year of maintaining the business in force (including investment management costs).
1.19. Commission payable to employees is to be dealt with as commission in the same way as commission paid to intermediaries and cedants unless the employees act as salesmen (as opposed to introducing business on a casual basis) in which case the payments are classed as management expenses (Instruction 2). Thus commission is usually to be regarded as a payment to outsiders rather than to an insurer’s employed sales force.

2. **Linked business (Forms 44, 45, 55 and 56)**

2.1. “Linked long-term” is defined by the Handbook glossary as long-term insurance contracts where the benefits are wholly or partly determined by reference to the value of or the income from property of any description (whether or not specified in the contract) or by reference to fluctuations in, or in an index of, the value of property of any description (whether or not so specified). A contract offering both linked and non-linked benefits is a linked contract. There are a number of important features of linked contracts in IPRU(INS), INSPRU and COBS of which the following will be considered in this section:

- permitted links
- the distinction between property-linked benefits and index-linked benefits and the implications for the assets matching these benefits
- close matching
- asset valuation rules
- the linked funds balance sheet on Form 44
- the revenue account for internal linked funds on Form 45
- Forms 55 and 56.

2.2. Forms 53 and 54, the valuation summaries for property-linked and index-linked contracts respectively, will be considered in section 4 of this chapter.

2.3. COBS 21.3.1R in the FCA Handbook prevents an insurer from contracting to provide benefits under linked long-term contracts of insurance that are determined, wholly or partly, or directly or indirectly, by reference to fluctuations in any index other than an approved index or wholly or partly by reference to the value of, or the income from, or fluctuations in the value of, property other than any of the types listed in COBS 21.3.1R(2). Bearing in mind that life insurance has a protection as well as a savings element, such restrictions are intended to protect policyholders by avoiding the use of unduly speculative property or indices as the determinant for policy benefits. COBS 21.3.1R(2) specifies eleven types of property that qualify:

(a) approved securities

(b) listed securities

(c) permitted unlisted securities (investments that are not listed securities but which are realisable in the short term)

(d) permitted land and property (direct interests in land and buildings, located in a territory meeting criteria specified in the Glossary definition, or such interests held indirectly through structures that do not pose a materially greater risk to policyholders than a direct holding)\(^{123}\)

\(^{123}\) Such interests may not normally be geared in excess of 10% of the gross asset value of the linked fund after specified adjustments, though this condition may be waived by the policyholder subject to specified conditions.
(e) permitted loans (loans with an approved credit institution, approved financial institution or approved investment firm, or with any person provided that the loan is documented by a written agreement setting out the rate of interest and the amount of, and due dates for, repayments and is fully secured by a mortgage or charge on permitted land or property that, if made to someone other than a body corporate, is not used wholly or mainly for domestic purposes)

(f) permitted deposits (deposits with an approved credit institution, approved financial institution or approved investment firm)

(g) permitted scheme interests (including an authorised fund, a recognised scheme, a UCITS scheme, a non-UCITS retail scheme and, for institutional linked policyholders, a qualified investor scheme or its EEA equivalent and any unregulated collective investment scheme that invests only in permitted links and publishes its prices regularly)

(h) cash

(i) permitted units (units or beneficial interests in any real or notional fund that only invests in permitted links and is managed either wholly by the insurer or wholly or partly by an agent on behalf of the insurer or a reinsurer in relation to a reinsurance contract with the insurer, for whom the insurer retains all responsibility towards its linked policyholders)

(j) permitted stock lending (a stock lending or repo transaction that satisfies INSPRU 3.2.36A to INSPRU 3.2.42G inclusive)

(k) permitted derivatives contracts (contracts that satisfy INSPRU 3.2.5R to INSPRU 3.2.35AG with the exception of INSPRU 3.2.18R in relation to assets covering liabilities in respect of linked long-term contracts of insurance).

2.4. COBS 21.3.2G indicates that COBS 21.3.1R does not prevent a firm from making allowance in the value of any permitted link for any notional tax loss associated with the relevant linked assets for the purpose of fair pricing. The FSA had explained its policy position in CP 07/7 that:

‘In our view, best practice and TCF [treating customers fairly] require unit-linked life funds to allow for tax in their unit-pricing in a way that is, as far as possible, financially neutral between firms and policyholders and between different groups of policyholders. To achieve this, firms may need to make allowance for notional tax losses on assets when it is prudent to do so. Although their use is common, such notional tax losses are not assets that are specifically permitted links under existing rules. We intend to make it clear that using such tax loss assets is acceptable for the purpose of fair pricing.’

2.5. Where such an approach is taken to unit pricing, it appears legitimate to regard the unit liability as matched by a deferred tax asset: INSPRU 1.1.20R exempts property-linked liabilities and index-linked from the general requirement for technical provisions to be covered by admissible assets, and the corresponding exemption at GENPRU 2.2.151R means that there would be no deduction from capital resources, notwithstanding that a deferred tax asset would be inadmissible in the context of non-linked business.

2.6. An “approved index” is defined by the Handbook glossary in relation to permitted links as follows.

(a) an index which is:

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124 Institutional linked policyholders are defined as the trustees of a defined benefit occupational pension scheme. In relation to other policyholders, investment in a qualified investor scheme or its EEA equivalent or of any unregulated collective investment scheme that only invests in permitted links and publishes its prices regularly is limited to 20% of the gross assets of the fund.
• calculated independently
• published at least once every week
• based on constituents that are permitted links
• calculated on a basis which is made available to the public and which includes both the rules for including and excluding constituents and the rules for valuation which must use an arithmetic average of the value of the constituents

(b) a national index of retail prices published by or under the authority of a government of a Zone A country

(c) an index which is:
• based on constituents that are permitted links
• in respect of which a derivative contract is listed

(d) the average earnings index when used for the purposes of orders made under section 148 of the Social Security Administration Act 1992 by the Department for Work and Pensions.

The rules on permitted links have changed over time. Whilst any fresh linkage is forbidden to an asset or index that was formerly a permitted link but no longer qualifies, a transitional provision allows linkage to continue in respect of contracts entered into before 1 July 1994 or in some specific cases 30 June 1995 or 1 February 1992 (COBS 21.1.2R).

The detailed rules permitting linking only to an approved index or to the eleven types of property are complemented by the following eight principles (which themselves have the status of rules) set out in COBS 21.2.1R to 21.2.8R.

► A firm must ensure that the values of its permitted links are determined fairly and accurately.

► A firm must ensure that its linked assets:
• are capable of being realised in time for it to meet its obligations to linked policyholders
• are matched with its linked liabilities as required by the close matching rules.

► A firm must ensure that there is no reasonably foreseeable risk that the aggregate value of any of its linked funds will become negative.

► A firm must notify its linked policyholders of the risk profile and investment strategy for the linked fund:
• at inception
• before making any material changes.

125 Although there is a lack of assets whose value is directly linked to the average earnings index, the FSA indicated when consulting on the addition of this category in CP 07/18 that waiver requests from insurers in the growing bulk annuity market that uses this index had demonstrated that it was usually possible to satisfy the close matching requirements by constructing a portfolio that gives an adequate match to the liabilities in the limited context of guaranteed minimum pensions. An insurer proposing to become involved with this business must notify the Regulator in writing, explaining how the associated risks will be safely managed (COBS 21.3.5R).
A firm must ensure that its systems and controls and other resources are appropriate for the risks associated with its linked assets and linked liabilities.

A firm must ensure when selecting linked assets that there is no reasonably foreseeable risk of a conflict of interest with its linked policyholders. If a conflict does arise, the firm must take reasonable steps to ensure that the interests of the linked policyholders are safeguarded.

In applying the rules in COBS 21, a firm must consider the economic effect of its permitted links and linked assets ahead of their legal form.

A firm must advise the appropriate Regulator in writing as soon as it becomes aware of any failure to meet the requirements of COBS 21 (which of the PRA or FCA, or both, is appropriate will depend on the requirement that has been breached).

2.9. The two elements (assets and indices) of permitted links in turn give rise to two separate definitions in Chapter 11 of IPRU(INS):

1. “Property-linked benefits” are defined as benefits other than index-linked benefits provided for under a linked contract of insurance:

2. “Index-linked benefits” are defined as benefits:
   • provided for under a linked contract of insurance
   • determined by reference to fluctuations in any index of the value of property (whether specified in the contract or not).

2.10. This distinction is of importance for classification and close linked purposes. Most of the time the classification will be clear-cut, but there can be borderline cases where an insurer holds assets whose value mirrors that of a permitted index, and it is consequently unclear whether these represent index-linked assets or property-linked assets. In these circumstances, the repealed Guidance Note 4.4\textsuperscript{126} indicated that there is a simple rule to apply. If the insurer bears the whole risk of counterparty default (so that policyholder benefits are wholly determined by the performance of the index) then the assets are index-linked. If, however, the contract is such that the benefits would be reduced (from those that would be calculated by reference to the index) to reflect part or all of the reduction in the value of the linked assets resulting from any counterparty default, then the assets are property-linked.

2.11. INSPIRU 3.1.57R and 3.1.58R impose on direct insurers a close matching requirement on linked business. Close matching is a strict requirement; a firm is not permitted to hold assets other than those required by these rules and seek to cover the mismatch by holding additional assets (INSPIRU 3.1.59G). Property-linked liabilities must be covered, under INSPIRU 3.1.57R, by:

1. (as closely as possible) the assets to which those liabilities are linked; or

2. a property-linked reinsurance contract; or

3. a combination of (1) and (2).

Index-linked liabilities must be covered, under INSPIRU 3.1.58R, by:

1. either:
   • the assets which represent that index or

\textsuperscript{126} In a similar way to the repealed Guidance Note 9.1, Guidance Note 4.4 may still provide a useful indication of the Regulators’ intention, although it has no official status.
Chapter 8 – Long-term insurance business

2.12. The insurer is required, as far as is practicable to hold assets whose value matches the unit liability. In this context, the repealed Guidance Note 4.4 made the following key points that may still be considered of some relevance:

► In general, where the benefits are linked to the value of certain assets, an insurer is not permitted to hold different assets and cover the mismatching by means of a reserve. However, in certain circumstances alternative assets may be held provided that they are assets of appropriate safety and marketability whose value matches that of the unit liability as nearly as may be.

► In the case of index-linked contracts, close matching may be possible through the transaction of an index derivative (although the appropriate safety and marketability tests should not be taken for granted). If such a derivative is not available (e.g. in relation to an RPI based contract), the requirements may be satisfied by active management of a suitable portfolio of instruments which, in combination, provide the best matching readily achievable in practice.

► Even though it does not fall under the usual understanding of an investment contract, a permanent health contract that provides disability benefits which are guaranteed to rise in line with the RPI would be an index-linked contract and the close matching rules would apply to the reserves held in respect of those benefits.

► The close matching test does not prevent surplus assets being kept within a linked fund. Temporary and unplanned small shortfalls of assets which match the unit liability are also permitted provided that a satisfactory mismatching reserve is held.

2.13. Assets held to cover index-linked benefits or property-linked benefits are exempt from the market risk and counterparty exposure limits of INSPRU 2.1. The exemption, provided by INSPRU 2.1.33R(6), does not extend to assets covering a guaranteed element of investment performance. This would capture, for example, contracts offering a minimum investment return, or annuity contracts with benefits linked to an index and providing (as is invariably the case) that benefits will not fall if the index does. Logically the corresponding gross mathematical reserves (again, excluding guaranteed benefits) do not count towards the business amount. Assets held in excess of those required to match the linked liability are subject to normal admissibility and concentration considerations. There is no exemption in GENPRU for linked business in respect of the general valuation rules, and GENPRU 1.3 is therefore also relevant.

2.14. The use of reinsurance is, as indicated above, permitted for linked business. However, specific rules apply where reinsurance is taken out. COBS 21.3.3R states that a firm that has entered into a reinsurance contract in respect of linked business must still discharge its responsibilities under the primary contract that it has issued, and COBS 21.3.4G that it should disclose to policyholders any credit risk that they are exposed to in respect of the reinsurer’s insolvency, and that it should suitably monitor the way the reinsurer manages its business. The repealed Guidance Note 4.4 indicated that a reinsurance contract was
unlikely to satisfy the “appropriate safety” test under the close matching rules if the reinsurer was not supervised in an EEA State, unless there were additional guarantees such as a deposit-back arrangement or a guarantee by an approved credit institution. The direct insurer would need to be able to call for reimbursement under the reinsurance contract whenever it was under an obligation to pay benefits to the policyholder (including non-discretionary benefits on early surrender).

2.15. Reference has been made in the previous paragraphs to an “internal linked fund”. Such a fund is defined by Chapter 11 as “an account to which an insurer appropriates certain linked assets and which may be sub-divided into units the value of each of which is determined by reference to the value of those linked assets”. An internal linked fund clearly provides property-linked benefits. There are three Forms within Appendix 9.3 specifically relating to internal linked funds:

► Form 44, providing an aggregate balance sheet (which also deals with directly held linked assets)
► Form 45, providing an aggregate revenue account
► Form 55 dealing with unit prices (which does not deal with directly held assets).

These Forms are required to be prepared for total business only.

2.16. Form 44 provides a balance sheet for linked funds as a whole: double-counting of items arising from cross-investment between internal linked funds is required to be eliminated. All assets held within internal linked funds must be included in the Form even if their value exceeds the corresponding value of linked liabilities to policyholders: there are now separate lines for the disclosure of surplus assets. The basis on which the assets have been valued is required to be stated in a supplementary note (code 4401).

2.17. The balance sheet is highly summarised: there is a three way split of assets (lines 11 to 13) and liabilities (lines 15 to 17) of internal linked funds and a single line (21) for directly held linked assets. The three way split of internal linked fund assets is into:

► directly held assets\(^{127}\) (excluding collective investment schemes) (line 11)
► directly held assets in collective investment schemes of connected companies (line 12)
► directly held assets in other collective investment schemes (line 13).

The three way split of internal linked fund liabilities is into:

► provision for tax on unrealised capital gains
► secured and unsecured loans
► other liabilities.

2.18. The net asset value for internal linked funds (line 18) will correspond to the fund carried forward for internal linked funds on Form 45 line 59.

2.19. If the surplus units at line 32 exceed 1% of the net unit liability, a statement of the purpose of the surplus units must be given in a supplementary note (code 4404). It is a little surprising that there are no prescribed supplementary note disclosures relating to deficit units at line

\(^{127}\) It is unfortunate that the terms “directly held assets” and “directly held linked assets” are used on the same Form with different connotations.
33. A further supplementary note (code 4405) requires disclosure of the name of fund, the net asset value and the liquidity ratio\(^{28}\) for any fund:

- whose net asset value is greater than £10 million, and with respect to which the liquidity ratio is negative and in excess of 0.05; or
- whose net asset value is greater than £500,000 and with respect to which the liquidity ratio is negative and in excess of 0.50.

2.20. The Instructions to Form 44 also require disclosures relating to derivatives to be included in supplementary notes (codes 4402 and 4403). The detail comprises:

(a) The aggregate value of rights (gross of variation margin) and the aggregate value of liabilities (gross of variation margin) under derivative contracts (or in respect of contracts or assets which have the effect of derivative contracts). The corresponding figures net of variation margin are also to be stated. For the purpose of the note, rights and liabilities are not to be set off against each other unless:

- such rights and liabilities may be set off against each other in accordance with generally accepted accounting practice
- such set off results (in whole or in part) from the closing out of obligations under a contract.

(b) Where there is a liability to repay variation margin and there are no arrangements for netting of amounts outstanding or the arrangements would not permit the accounting of such amounts on a net basis in accordance with generally accepted accounting practice this is to be stated.

2.21. The requirements under (a) are analogous to the information provided for non-linked business on Form 17.

2.22. Form 45 represents an aggregate revenue account for internal linked funds. As with Form 44, Instruction 1 requires double counting arising from cross investment between internal linked funds to be eliminated. The line narratives are self-explanatory and the only points to watch are:

- Where there are any differences between brought forward amounts and the corresponding carried forward amounts in the previous return, a supplementary note (code 4501) is required.
- There are “other income” and “other expenditure” lines on the Form (14 and 26 respectively), which include items that cannot properly be allocated to lines 11 to 13 or 21 to 25. A supplementary note (code 4502) is required to give particulars of any items included at these lines.
- The gross value of units created is required to be shown at line 11 and the gross value of units cancelled at line 21 (Instruction 3). This contrasts with the old Form 51 where a net creation or cancellation value was required to be shown for each fund. The repealed Guidance Note 9.1 indicated that this gross disclosure is required so that turnover can be monitored. Each day’s movements may be netted or recorded as two separate entries, one positive and one negative, as is administratively convenient. In practice, some insurers may find it difficult to obtain this information on a daily basis.

\(^{28}\) Defined in Instruction 7 to Form 44 as the sum of the values of approved securities, short term deposits and cash held in the fund less liabilities, expressed as a ratio of the net asset value of the fund. Where the liabilities exceed the assets referred to, the liquidity ratio is negative.
The design of the Form, unlike that of Form 40, does not specifically cater for transfers of business. Care should be taken to ensure that the supplementary note disclosures in respect of this Form indicate the approach that has been taken to transfers.

2.23. In addition to the disclosures so far considered, information about material internal linked funds is also to be found on Form 55. This Form concentrates on unit prices, with column 7 reporting the unit price at the current valuation date, column 6 the unit price at the previous valuation date and column 8 the change during the year (column 7 minus column 6 divided by column 6). This Form only needs to be prepared for an internal linked fund if:

- the net assets\(^{129}\) held for the fund and any other internal linked funds sharing the same underlying assets for pricing purposes exceed the lesser of £100 million and 10% of the total internal linked funds (Form 45 line 59)
- it is not a share-index tracker fund
- it is in one of 21 categories of fund itemised in Instruction 2.

2.24. If a fund is required to be reported, then in addition to the name of the fund (column 1), type of the fund (column 2) and the unit price information already referred to, it is necessary to state the total net assets attributable to the fund (column 3), the name of the largest series by unit value (column 4) and the unit management charge for the largest series (column 5).

2.25. Form 56 provides a prescribed analysis of assets matching index-linked liabilities (lines 11 to 20), and an analysis of the credit rating of other fixed interest and other variable interest securities (lines 31 to 39, only required if the sum of such securities at lines 12 and 14 exceeds £100m), similar to that provided for non-linked assets on Form 49. The volume of RPI linked annuities has increased significantly as a result of buyouts of occupational pension scheme liabilities, and the limited supply of index-linked gilts and the availability of swaps has led firms to use alternative investment strategies to meet the Regulator’s matching requirements. The design of the Form recognises that firms may use fixed interest assets and swaps to back index-linked annuities, and prescribes a split of assets to highlight this. The Regulator at one time contemplated requiring also an analysis of asset backed securities but has decided to rely on private surveys for the time being.

2.26. The Form has two columns, dealing respectively with value of assets (which in the case of equity index derivatives and inflation swaps at lines 16 and 17 are to be stated net of any variation margin) and mean term (the latter is not a relevant concept for lines 15 to 20). The mean term may be calculated by using the expected yearly cashflows discounted by the internal rate of return, or an alternative actuarial method: undated stocks are required by Instruction 2 to be assumed to be redeemed after 40 years. A de minimis limit applies to the Form, which is only required if index-linked assets (Form 13.58.1, to which Form 56.20.1 must agree) exceed £100m. Consequently, the Regulator expects that only a small number of firms, mainly the annuity writers, will be required to complete Form 56. There is just one prescribed supplementary note: where lines 31 to 39 are completed, the rating agency used to provide the split by credit rating must be stated in supplementary note 5601.

3. **Actuarial roles and responsibilities**

3.1. The actuary has a key role to play in any life insurer since it is only through the application of actuarial science that life premium rates can be determined on a sound basis. An actuary fulfils many functions in such areas as product design, premium rating and profitability studies, as well as valuation of liabilities, and may hold other senior positions in some insurers. Prior to 31 December 2004 the “appointed actuary” had a role of central significance, and in the context of the return was responsible for the Appendix 9.4 valuation

\(^{129}\) The net asset figure used includes holdings in other funds. As a result, fund prices in large managed funds will be reported even if there are no assets which are directly held by the managed fund.
Chapter 8 – Long-term insurance business

report (together with the Forms that were within Appendix 9.4 at the time) and a certificate upon which the auditor relied in giving its report for the mathematical reserves and required minimum margin for long-term insurance business. However, concerns arose that the responsibilities held by the appointed actuary might lead the directors and senior managers to place too much reliance on the view of the appointed actuary rather than reaching their own views after obtaining actuarial advice. As a consequence, the position of appointed actuary was abolished and there are now two separate actuarial functions with a different spread of responsibilities between them and the directors and senior managers. This section considers these two functions and the rule 9.36 statement which gives information on the actuary appointed to perform the with-profits actuary function.

3.2. At the same time, the scope of the audit was extended to embrace the mathematical reserves, with the auditor required to obtain advice from an actuary independent of the insurer.

3.3. SUP 4.3.1R requires any firm with permission to effect or carry out long-term insurance contracts (other than certain friendly societies):

- to appoint one or more actuaries to perform the actuarial function and (if there is with-profits business) the with-profits actuary function
- to notify the PRA without delay when it is aware that a vacancy in either actuarial office will arise or has arisen, giving the reasons
- to appoint an actuary to fill any vacancy that has arisen
- to ensure that the replacement actuary can take up office at the time the vacancy arises or as soon as reasonably practical after that.

3.4. Acting in either actuarial capacity is specified as a controlled function and advance application for approval by the PRA with the consent of the FCA is therefore necessary before an appointment can be made. The actuary must be a fellow of the Institute and Faculty of Actuaries, although it would be open to a non-UK insurer to apply for a waiver to enable it to appoint an actuary with an appropriate overseas actuarial qualification. EU qualified actuaries may obtain fellowship of the Institute under mutual recognition provisions, subject to conditions. It is possible to appoint a firm of actuaries rather than an individual, though in this case each of the partners in the firm must possess the prescribed qualifications.

3.5. An actuary appointed to perform the actuarial function has the following responsibilities under SUP 4.3.13R.

1. To advise the firm’s management on the risks the firm runs in so far as they may have a material impact on the firm’s ability to meet liabilities to policyholders in respect of long-term insurance contracts as they fall due and on the capital needed to support the business, including regulatory capital requirements.

2. To monitor those risks and inform the firm’s management if he has any material concerns or good reason to believe that the firm:

- is not meeting liabilities to policyholders under long-term insurance contracts as they fall due, or may not be doing so, or might not have done so, or might, in reasonably foreseeable circumstances, not do so

130 There is a third actuarial function, that of the Lloyd’s actuary, which falls outside the scope of this booklet.

131 An actuary who was the appointed actuary of a firm prior to 31 December 2004 could assume either or both of the new actuarial functions for that firm on that date without a formal approval process being required, but the FSA was required to be informed that this had taken place.

132 SUP has not yet caught up with the 2010 merger of the English and Scottish bodies and still refers to them separately.
is, or may be, effecting new long-term insurance contracts on terms under which the resulting income earned is insufficient, under reasonable actuarial methods and assumptions, and taking into account the other financial resources that are available for the purpose, to enable the firm to meet its liabilities to policyholders as they fall due (including reasonable bonus expectations)

► does not, or may not have, sufficient financial resources to meet liabilities to policyholders as they fall due (including reasonable bonus expectations) and the capital needed to support the business, including regulatory capital requirements or, if the firm currently has sufficient resources, might, in reasonably foreseeable circumstances, not continue to have them.

3. To advise the firm’s governing body on the methods and assumptions to be used for the investigations required by rule 9.4 of IPRU(INS) and the calculation of the with-profits insurance capital component under INSPRU 1.3 as applicable.

4. To perform those investigations and calculations in (3), in accordance with the methods and assumptions determined by the firm’s governing body.

5. To report to the firm’s governing body on the results of those investigations and calculations in (3).

3.6. An actuary appointed to perform the with-profits actuary function has the following responsibilities under SUP 4.3.16AR.

1. To advise the firm’s management, at the level of seniority that is reasonably appropriate, on key aspects of the discretion to be exercised affecting those classes of the with-profits business of the firm in respect of which he has been appointed.

2. Where the firm is a realistic basis life firm (see paragraph 6.3 below), to advise the firm’s governing body as to whether the assumptions used to calculate the with-profits insurance component under INSPRU 1.3 are consistent with the firm’s Principles and Practice of Financial Management (“PPFM”) in respect of those classes of the firm’s with-profits business.

3. At least once a year, to report to the firm’s governing body on key aspects (including those aspects of the firm’s application of its PPFM on which the advice described in (1) has been given) of the discretion exercised in respect of the period covered by his report affecting those classes of with-profits business of the firm.

4. In respect of each financial year, to make a written report addressed to the relevant classes of the firm’s with-profits policyholders, to accompany the firm’s annual report under COBS 20.4.7R, as to whether, in his opinion and based on the information and explanations provided to him by the firm, the annual report and the discretion exercised by the firm in respect of the period covered by the report may be regarded as taking, or having taken, their interests into account in a reasonable and proportionate manner.

5. To request from the firm such information and explanations as he reasonably considers necessary to enable him properly to perform the duties in (1) to (4).

6. To advise the firm as to the data and systems that he reasonably considers necessary to be kept and maintained to provide the duties in (5).

3.7. In principle it is possible for the same actuary to be appointed to both the actuarial function and the with-profits actuary function. However, the following provisions to prevent conflicts of interest appear in SUP 4.3.12AR:

► Neither actuary may be the chairman or chief executive of the firm.
The actuary performing the with-profits actuary function may not be a member of the firm’s governing body.

Neither actuary may perform any other function on behalf of a firm which could give rise to a significant conflict of interest.

3.8. The possibility of conflicts of interest has long been recognised in the reporting requirements, and information must be presented about any significant investment or other financial interest of any actuary performing the with-profits actuary function at any time during the financial year, in the insurer for which he holds office. Rule 9.36 requires a statement of the following information in respect of the actuary, including his spouse, civil partner and minor child, business partner, person (other than the insurer) of which he is an employee or body corporate (other than the insurer) of which he is a director or which is controlled by him.

(a) Particulars of any shares in, or debentures of, the insurer (including, for the purposes of this rule, parent, subsidiary and fellow subsidiary undertakings of the insurer) in which the actuary was interested at any time during the year (interest is defined by reference to Schedule 1 to the Companies Act 2006); the particulars will include a general description of the investments, name of the holder, nominal or principal amount outstanding and rate of interest and terms of repayment where applicable.

(b) Particulars of any pecuniary (beneficial) interest of the actuary in any transaction between the actuary and the insurer subsisting at any time during the year (a general description will suffice in the case of transactions of a minor character). In the case of a life policy the particulars will include sum assured, annual premium, etc.

(c) The aggregate amount of

(i). remuneration and other benefits receivable for acting as actuary under a contract of service or contract for services

(ii). emoluments, pensions or compensation for acting as director which are required to be disclosed in the Companies Act accounts (the position in relation to a non-UK insurer is unclear).

(d) A general description of any other pecuniary benefit (including any pension and other future or contingent benefit which are to be excluded from (c)(i)) received in the year or receivable from the insurer.

3.9. Since the insurer will not necessarily be aware of all the interests which may arise, an additional statement must be included indicating that the insurer has made a request to the actuary to furnish to it the particulars specified. Any particulars furnished pursuant to that request must be identified. The intention of this is that the insurer should be able to rely on the information given to it by the actuary but an insurer could still be held responsible if the statement was known by one of the directors to be false or incomplete.

3.10. Section 2 of chapter 9 discusses “whistle blowing” in the context of the direct reporting by auditors to the Regulator. The general principle of section 342(3) of FSMA applies equally to actuaries, and consequently an actuary holding either of the relevant controlled functions will not be held to contravene any duty to which he is subject merely because he gives a Regulator information on (or his opinion on) a matter which he has become aware of in his capacity of actuary to an insurer, provided that he is acting in good faith and reasonably believes that the information or opinion is relevant to any functions of the Regulator. The section also allows the Treasury to make regulations prescribing circumstances in which an actuary must communicate information to a Regulator (i.e. a duty as distinct from a right to report). Such circumstances were duly prescribed by the Financial Services and Markets Act 2000 (Communications by Actuaries) Regulations 2003 (2003 No. 1294).
4. Other Appendix 9.3 Forms (Forms 46 to 54 and 57 to 59B)

4.1. The Forms in Appendix 9.3 not dealt with in section 1 or 2 above are considered in this section except for Form 60 which was discussed in chapter 3. The Forms fall into a number of groups:

► Forms 46 and 47 dealing with new business
► Forms 48 and 49 providing yield information in respect of non-linked assets
► Forms 50 to 54 providing a valuation summary
► Forms 57 analysing the valuation interest rate
► Form 58 showing the distribution of surplus
► Forms 59A and 59B providing information on with-profits payouts.

4.2. Form 46 provides a one page summary of the new business reported in detail on Form 47 (to which the figures will agree). It includes the column structure familiar from Forms 41 to 43 of UK Life, UK Pension, Overseas and Total, together with a comparative column. Also familiar from Form 41 is the vertical split between regular and single premium. This form requires:

► a split of inward business into direct, external and intra-group reinsurance, complementing the separate identification of intra-group outward reinsurance on Forms 41 and 43; and

► disclosure of the number of new policyholders/scheme members for direct insurance business, reflecting the reporting of policyholders rather than contracts. A new policyholder or scheme member is one who has effected a new individual contract or joined the scheme during the financial year (Instruction 2). New regular premiums and new single premiums are premiums from new policyholders and scheme members and must also include new increments on existing policies accepted by the insurer during the financial year.

4.3. Form 47 must be prepared separately for UK Life, UK Pension and Overseas, and for each of these in respect of direct insurance business, reinsurance accepted external and reinsurance accepted intra-group. There are therefore nine possible combinations in total. Although Instructions 1 and 2 could be taken to imply that there will be one long form, these simply define the order in which the pages are submitted. The insurer has discretion to subdivide Overseas by state or territory. The information required includes information on premiums, and on numbers of policyholders. Columns 3 and 5 (relating to number of policyholders/scheme members) will only be completed for direct business accepted, and will not be completed for reinsurance acceptances. Where, in relation to direct business accepted, the insurer does not have records of benefits at member level for a group scheme, columns 3 and 5 will be zero, but a supplementary note (code 4701) must be included to specify the number of such new group schemes divided by product code. Details must also be given in a supplementary note of approximations made in determining columns 3 and 5 (code 4703).

4.4. Form 47 presents a breakdown of information by product code. An insurer may include more than one line on Form 47 for the same product code within a type and source of business to identify specific brands. Details of approximations used to apportion between product codes must be provided in a supplementary note (code 4702). The product codes themselves, which also apply to Forms 51 to 54, are listed in Instruction 3 to Form 47. There are 106 product codes in total and these break down into groups with:

► 100 – 215 (24 codes) corresponding to with-profits business on Form 51
4.5. Forms 48 and 49 provide information on yields of non-linked assets. There are restrictions on the rate of interest that can be used for the calculation of the net present value of a long-term insurance liability in determining mathematical reserves. INSPRU 3.1.28R provides that this should not exceed 97.5% of the risk adjusted yield that is expected to be achieved on:

► the assets allocated to cover the liability
► the reinvestment of sums expected to be received from those assets
► the investment of future premium receipts.

4.6. In addition, INSPRU 3.1.29R requires the rates of interest assumed to allow appropriately for the rates of tax that apply to the investment return on policyholder assets. By providing information on the yields on the assets held at the balance sheet date, the Forms provide a benchmark for the rate used. It is not possible to derive the rate directly from these Forms as these are based purely on the assets held on the balance sheet date, make no allowance for tax, and do not reflect the 97.5%.

4.7. Forms 48 and 49 are prepared separately for each long-term insurance fund for which a Form 13 is prepared, and there are a number of links prescribed in the Instructions between lines on Form 48 and lines on Form 13. Form 48 provides the overall analysis and Form 49 provides additional information on fixed and variable interest securities, but the latter is only required if non-linked securities which are not approved securities (i.e. Form 48.13.2 + 48.23.2) exceed £100 million.

4.8. The design of Form 48 is largely intended to fit with realistic reporting and PPFM (see paragraph 3.6 above and 1.6 of Chapter 9) by identifying assets backing with-profits business, and includes a number of important features.

► The asset lines distinguish between assets backing non-profit liabilities and non-profit capital requirements (lines 11 to 19) and assets backing with-profits liabilities and with-profits capital requirements (lines 21 to 29).

► In addition to column 1 ("unadjusted assets") which ties back to Form 13, there is a column 2 indicating economic exposure. In effect a look through is applied to collective investment schemes, collective investment pools, shares in an undertaking that is primarily a holding company for equity shares or property and to derivatives that give rise to an obligation to acquire an asset or which are in the money. It is possible for “other assets” to be negative in column 2.

► Column 5 specifies the return, expressed as a percentage, on with-profits assets in the financial year, with additional lines 31 to 33 provided in respect of the overall with-profit return which only have to be completed for this column.

4.9. The required relationships between column 1 and Form 13 are specified by Instruction 1. These include a requirement to unbundle accrued interest at Form 13 line 84 and allocate this over the various security headings. Equity shares (Form 13 line 41) have to be broken down on Form 48 into UK listed equity shares (lines 15 and 25), non-UK listed equity shares (lines 16 and 26) and unlisted shares (lines 17 and 27). A fund without with-profits business will report all assets at lines 11 to 19. A with-profits fund will include at lines 11 to 19 assets equal to the non-profit mathematical reserves (Form 50 lines 42, 45 and 47) plus the relevant
part of the long-term insurance capital requirement and resilience capital requirement if these are backed by assets in that fund and will include all other assets at lines 21 to 29.

4.10. Column 3 reports expected income from the assets as classified in column 2. This represents the amount before deduction of tax which would be received in the next financial year on the assumption that the assets will be held throughout that year, and that the factors which affect income will remain unchanged. However, account does have to be taken of changes in those factors known to have taken place by the end of the financial year, and in particular changes in the following factors indicated by INSPRU 3.1.33R:

1. changes in the rental income from real estate
2. changes in dividends or audited profit on equities
3. known or forecast changes in dividends which have been publicly announced
4. known or forecast changes in earnings which have been publicly announced
5. alterations in capital structure
6. the value (at the most recent date for which it is known) of any determinant of the amount of any future interest or capital payment.

4.11. If asset values in column 2 have been restricted because of the application of the market risk and counterparty limits, the expected income is, in the interests of consistency, only included to the same extent. The treatment of the expected income from any asset where the payment of interest is in default and the amount of interest involved must be stated in a supplementary note (code 4802).

4.12. The yields included in column 4 are a mixture of gross redemption yields for fixed and variable interest securities (lines 12 to 14 and 22 to 24) and running yields. The totals at lines 19 and 29 represent a weighted average of the yields reported at earlier lines of the Form, with the weights being the column 2 values (so one would not, save in the unusual circumstances where there were no fixed or variable interest securities, expect the total yield to equate to the running yield of the total expected income as a percentage of total asset value). Assets not producing income are required to be included in the calculation. Gross redemption yields are required to be calculated in accordance with INSPRU 3.1.34R(2). This rule specifies the use of an internal rate of return, which is defined by INSPRU 3.1.39R as the annual rate of interest which, if used to calculate the present value of future income (before deduction of tax) and of repayments of capital (before deduction of tax), would result in the sum of those amounts being equal to the value of the asset, before any allowance for tax required by INSPRU 3.1.29R and leaving out of account any adjustment considered necessary because of:

(a) INSPRU 3.1.41R for credit risk (although this will feature on Form 49 where that Form is prepared); or

(b) INSPRU 3.1.46R, which restricts, for the with-profits insurance contracts of a realistic basis life firm, the risk-adjusted yield assumed for the investment or reinvestment of sums denominated in sterling to the rates derived from the forward gilts yield.

4.13. Where securities can be redeemed over a period at the option of the issuer or guarantor, it should normally be assumed for the purpose of calculating the yield that these will be redeemed at the latest possible date: if any other assumption is made, this should be explained in a supplementary note (code 4803).

4.14. Running yields in column 4 will normally\(^{133}\) be determined in accordance with INSPRU 3.1.33R and INSPRU 3.1.34R before any allowance required by INSPRU 3.1.29R. There are

\(^{133}\)There are some slightly obscure exceptions referred to in instructions 13 and 14 to the Form.
two exceptions to this requirement. The running yield is not necessarily just the expected income as a percentage of the asset value. For equity shares, the yield to be based on the average of the dividend yield and the earnings yield, where this gives a higher result than the dividend yield. The earnings yield is based on audited profits (including extraordinary and exceptional items) and is required to be calculated by reference to whichever is the more appropriate to the issue of UK, US or international generally accepted accounting practice.

4.15. The following supplementary notes, in addition to those referred to in the preceding paragraphs, may be required in relation to Form 48.

► 4801 – where more than 10% of the total with-profits mathematical reserves results from with-profits business results from with-profits business where it is the insurer’s practice to restrict policyholders’ participation in any eligible surplus to that arising from only a part of the fund, prescribed information including brand names. The precise detail to be given varies depending upon the insurer’s asset share philosophy for the block of business (Instruction 6).

► 4804 – the weighted average of the yield for “other assets” reported at line 18 or 28 determined in accordance with INSPRU 3.1.34R(2) (i.e. as an internal rate of return) before any allowance for tax required by INSPRU 3.1.29R, where this is significantly different from the running yield reported in column 4 (Instruction 11).

► 4805 – where an entry at Form 13.87.1 has resulted from excess exposure to a counterparty or excess exposure to a number of counterparties, the aggregate value of the assets giving rise to such exposure must be stated, together with the expected income from those assets (Instruction 12).

► 4806 – the assets that have been used to calculate the investment returns shown in lines 21 to 29 of column 5 (Instruction 15). The assets used will not necessarily be the same as the assets in columns 1 and 2.

4.16. Where Form 49 is required because the materiality limits are exceeded, the analysis will provide a split of fixed interest securities which are not approved securities by credit rating, ranging from AAA/Aaa at line 31 to unrated at line 38. The rating agency used to provide the split by credit rating is required to be disclosed in a supplementary note (code 4901). The Form has four columns:

► Column 1 indicates the value of assets which will equate to column 2 (economic exposure) of Form 48, combining the non-profit and with-profit lines on that Form.

► Column 2 specifies mean term, which is required by Instruction 3 to be calculated using the expected annual cash flows discounted by the internal rate of return, or by an alternative actuarial method. Undated stocks must be assumed to be redeemed after 40 years.

► Column 3, described as “yield before adjustment” indicates the gross redemption yield, calculated in accordance with Instruction 10 to Form 48.

► Column 4 is described as “yield after adjustment”. The adjustment in question is the risk adjustment required by INSPRU 3.1.41R (which requires the yield to be reduced to exclude that part which represents compensation for credit risk arising from the asset) and INSPRU 3.1.44R (which requires provision for credit risk for securities that are not credit-rated to be made on principles at least as prudent as those adopted for credit-rated securities).

4.17. The valuation summary is spread over the following five Forms:

► Form 50 – summary

► Form 51 - non-linked contracts other than accumulating with profit policies

► Form 52 - accumulating with profit policies
Form 50 provides a useful summary of key data from the underlying Forms. Its architecture is similar to Forms 41 to 43 and 46, with separate columns for UK life, UK pension, overseas, total and previous years and a vertical analysis organised into sections dealing with gross, external reinsurance, intra-group reinsurance and net. With-profits and non-profit business are derived separately from Form 51 by reference to product codes, while linked and non-linked business are derived from separate columns on Forms 53 and 54.

Forms 51 to 54 are required to provide separate valuation summaries for each fund or part of a fund for which a surplus is determined, and to show separate information for the basic subdivisions of UK life, UK pension and overseas (with the insurer having the discretion to subdivide overseas business by state or territory). The information must also present in sequence the now familiar analysis into gross insurance business, reinsurance business ceded which is external to the insurance group and reinsurance ceded which is within the insurance group and categorise product information on the basis of the prescribed product categories, in order to allow comparison across firms of product types and risks. There is a de minimis limit permitting products to be classified as miscellaneous where neither the gross mathematical reserves nor the gross annual premiums with respect to products for the same product code exceed the lesser of £10 million and 1% of the gross mathematical reserves. This test is carried out at firm level, combining all sub-funds. It is possible for figures on these Forms (and therefore on Form 50) to be negative.

All four Forms have the same nine columns, but columns 6 to 8 (nominal value of units, discounted value of units and other liabilities) are marked “n/a” on Form 51. The following supplementary notes to the Forms are required:

- 5101 – 5401 – the number of group schemes, divided by product code, for which the insurer has no record of benefits at member level (Instruction 6)
- 5102 - 5202 – approximations made in estimating the number of policyholders from the number of contracts (Instruction 6)
- 5103 - 5403 – details of any product in excess of the de minimis limits reported under the miscellaneous code because this does not appear to fit in any other product code (Instruction 12)
- 5104 - 5404 – approximations used to apportion between product codes (Instruction 13).

Form 57 is entitled “Analysis of valuation interest rate”. It is prepared for each separate fund or part of a fund for which a surplus is determined where mathematical reserves for non-linked business exceed £100 million. Disclosure is required by product group (the column 1 narrative must be sufficient to provide an easy cross-reference to Forms 51 to 54), with separate lines being provided:

- for UK and overseas liabilities, for life assurance and annuity business, pension business, permanent health and other business and for with-profits and non-profit business
- for each separate asset mix determined by the notional allocation of assets to contracts
- for each valuation interest rate.

Columns are provided on this Form for mathematical reserves net of reinsurance ceded (including any increase in reserves resulting from the bonus declaration for the year), net valuation rate, gross valuation interest rate and the risk adjusted yield on matching assets allowing for the adjustments from INSIPRU 3.1.41R. Up to 10% of the total relevant liabilities for a fund may be shown in a line labelled “Misc” in column 1: if advantage is taken of this,
columns 3 and 4 must be marked “n/a”. A supplementary note (code 5701) must be included where negative mathematical reserves on one group of products have been included to offset positive mathematical reserves on another group of products, giving details of the amounts and the products concerned.

4.23. Form 58 is prepared for total business and for each sub-fund, and indicates how surplus has arisen and analyses its distribution. Surplus once quantified can be dealt with through a combination of the following three ways:

► allocated to policyholders
► allocated to shareholders
► carried forward unappropriated.

4.24. Lines 11 to 21 of Form 58 arrive at the amount (on line 29) of surplus that is available for distribution. This is done by comparing the sum of mathematical reserves with the fund carried forward. It is necessary to adjust the fund as stated in the revenue account (Form 40 line 59) for two main reasons:

(a) Bonus payments (interim, mortuary or terminal) determined and paid to policyholders prior to the end of the financial year in anticipation of a surplus arising at the valuation date need to be added back to arrive at the surplus before any distribution. Instruction 3 emphasises that this treatment only applies to amounts actually paid: any special provision made but not paid is to be treated as an “other bonus” allocated on the valuation date and included at line 44. A supplementary note (code 5801) must identify the various items where necessary.

(b) A transfer from Form 40 to Form 16 represents a distribution of surplus to shareholders and therefore also needs to be added back.

4.25. Lines 31 to 39 demonstrate how the surplus shown at line 29 has arisen. This may be unappropriated surplus brought forward from the last valuation (equal to line 49 of Form 58 for the previous year) or surplus arising since the last valuation (line 34 – effectively a balancing figure). The other possibility is that there has been a transfer into the fund – e.g. from Form 16 in respect of investment income or net capital gains arising on shareholder assets or to make good a deficit that would otherwise have arisen in the fund. One important point needs to be made in connection with transfers. If there is a net transfer into the fund, aggregating transfers from Form 16 and transfers from other funds or part of funds (but excluding reserves which do not contribute to surplus), lines 32 and 33 are completed, with a figure at line 32 or 33 in brackets if necessary; if there is a net transfer out, lines 13 and 14 are completed. It is wrong to complete both lines 13 and 14 and lines 32 and 33. If the entry in line 14 or line 33 represents more than one transaction, each transfer is to be identified separately in a supplementary note (code 5802).

4.26. The distribution of surplus is analysed at lines 41 to 59, with the allocation to policyholders being subdivided into cash bonuses (line 42), reversionary bonuses (line 43), other bonuses (line 44) and premium reductions (line 45). As will be discussed in the next section, Appendix 9.4 contains a description of the principles on which the distribution of profits among policyholders and shareholders is made, as referred to in the constitution of the insurer or in provisions made thereunder, or in any policy or any advertisement. There is a general constraint on the insurer’s freedom of action in this area as a result of rule 3.3 of IPRU(INS). Where there is an established surplus in which long-term insurance policyholders of any category are eligible to participate and an amount was allocated to such policyholders in respect of a previously established surplus, then an insurer shall not transfer assets (i.e. allocate part of surplus) to the shareholders unless an amount at least equal to the relevant minimum has been allocated to the policyholders. The relevant minimum is arrived at by applying the formula:
\[
\frac{b \times c}{a} - c
\]

where:

a  is the last previously established surplus in respect of which an amount was allocated to policyholders of the category in question, excluding any unappropriated surplus carried forward (i.e. line 48 in the comparative column)

b  is the amount then allocated to policyholders (line 46 in the comparative column)

c  is the present surplus (i.e. line 48).

4.27. The position is also highlighted on Form 58, since the percentage of distributed surplus allocated to the policyholders for the current year is shown at line 61, with the corresponding percentage at the three immediately previous valuations at lines 62 to 64. The comparison is only required on the sub-fund Forms. An insurer may distribute less than the relevant minimum only if it has served written notice on the FCA and published an approved statement in the official Gazettes at least 56 days before the allocation to shareholders takes place. A number of life insurers have used this provision to distribute ‘orphan’ assets within the life fund to shareholders.

4.28. With-profits payouts are reported on Forms 59A and 59B, dealing respectively with payouts on normal retirement and payouts on surrender. These Forms are required to show the payouts as at 2 months and 1 day after the valuation date (i.e. 1 March for an insurer with a 31 December year end). The heading specifies the original insurer, defined by Instruction 1 as the insurance undertaking which effected the policy (which in most cases will be the same entity as the insurer preparing the return). There is a \textit{de minimis} limit, which means that these Forms only need to be prepared where the with-profits mathematical reserves of the original insurer exceed £100 million.

5. \textbf{Abstract of valuation report (Appendix 9.4)}

5.1. Rule 9.4 requires any insurer carrying on long-term insurance business to “cause” an investigation into the financial condition of the business to be made, in accordance with the methods and assumptions determined by the insurer, by the holder of the actuarial function and an abstract of the report to be prepared. An abstract is also required if, at an interim date, an investigation of the financial condition of the long-term insurance business has been made with a view to the distribution of profits or the results of which are made public. The investigation includes both a valuation of the long-term insurance business liabilities and a determination of any excess of the assets over the liabilities. The abstract of the actuary’s report is normally required by rule 9.31(a) to comply with the requirements of Appendix 9.4 and to contain the information specified in the Appendix. However, abbreviated reporting requirements apply for interim valuations (see paragraph 5.14).

5.2. Appendix 9.4 is structured into ten paragraphs, which are intended to allow users to see clearly the information which relates to particular areas (e.g. options), and the abstract is required to adopt this numbering. Each of these paragraphs is considered below, although the outline given below is deliberately brief, since a full analysis would be outside the scope of this publication. In summary these paragraphs deal with the following subject matter:

1. Introduction
2. Product range
3. Discretionary charges and benefits
4. Valuation basis (other than special reserves)
5. Options and guarantees
6. Expense reserves
7. Mismatching reserves
8. Other special reserves
9. Reinsurance
10. Reversionary (or annual) bonus.

5.3. Paragraph (1) begins by indicating the date to which the actuarial investigation relates, namely the valuation date (i.e. the date as at which the liabilities are being determined). It then indicates the date to which the previous investigation related (valuations must be performed at least annually). Finally, the paragraph identifies the dates of any interim valuations carried out (for the purposes of rule 9.4) since the previous valuation date. A full interim valuation for the purpose of publication or distribution of profits would be relevant for this paragraph, but an informal valuation or a valuation produced at the request of the Regulator would not be.

5.4. Paragraph (2) requires details of any significant changes in products during the financial year (new products, new bonus series, products withdrawn or changes to options or guarantees under existing products) including product brand names and charging methods, but not the amount of the charges where these form part of the product terms.

5.5. Paragraph (3) provides information on discretionary charges and benefits. There are 10 separate sub-paragraphs which it would be beyond the scope of this publication to cover in detail. Among the prescribed disclosures are:

► market value reductions applied during the year
► the interest rate added during the year for non-profit deposit administration benefits;
► the percentage change to service charges for in-force linked policies, and any changes to benefit charges on such policies
► for internal linked funds, details of unit pricing, tax deductions and tax provisions.

5.6. Paragraph (4) provides information on the valuation basis (other than special reserves which are covered in paragraphs (5) to (8)). To enable users to identify changes in the basis, the presentation is by way of a table showing the previous year’s basis and the current year’s basis – this applies to interest rates, mortality bases, morbidity bases and expense bases. The prescribed disclosures are required where either the gross mathematical reserves or gross annual premium for a group of products using the same valuation method and basis exceeds the lesser of £10 million and 1% of gross mathematical reserves.

5.7. Paragraph (5) provides in one section all the information on options and guarantees. The intention is to enable users to see more clearly insurers’ exposure to different guarantee risks. There are separate sections dealing with guaranteed annuity rate options, guaranteed surrender and unit-linked maturity values, guaranteed insurability options and other options and guarantees.

5.8. Paragraph (6) provides in one section all the information on expense reserves. The disclosures expense loadings expected to arise in the twelve months following the valuation date to meet contracts then in force, and new business expense overrun reserves.

5.9. Paragraph (7) provides information on mismatching reserves. This includes a table of mathematical reserves and deposits received from reinsurers by currency with details of
matching assets and the amount of any currency mismatching reserve, and also (for a non realistic basis life firm) reports the resilience capital requirement.

5.10. Paragraph (8) provides a description of the nature and amount of any other special reserves that exceed the lesser of £10 million and 0.1% of gross mathematical reserves. Where the reserve is greater than the lesser of £10 million and 0.5% of gross mathematical reserves, a description of the method and basis used to calculate each reserve must be provided.

5.11. Paragraph (9) provides information on outward reinsurance, with separate requirements for treaty and facultative arrangements. Prescribed details have to be given for a treaty if:

► it is a financing arrangement

► premiums payable by the insurer under the treaty for the report period exceed the lesser of £10 million and 1% of total gross premiums written

► mathematical reserves ceded under the treaty exceed the lesser of £10 million and 1% of total gross mathematical reserves.

5.12. There is no de minimis limit for reporting in this paragraph of facultative reinsurance ceded, although disclosure is only required in respect of reinsurers that are not authorised to carry on insurance business in the United Kingdom. A financing arrangement is defined as any contract entered into by the insurer in respect of the insurer’s contracts of insurance which has the effect of increasing the long-term capital resources at Form 2 line 11 and which includes terms for:

► the transfer of assets to the insurer, the creation of a debt to the insurer or the transfer of liabilities to policy holders from the insurer (or any combination of these)

► either an obligation for the insurer to return (either with or without interest) some or all of such assets, a provision for the diminution of such debt or a provision for the recapture of such liabilities, in each case in specified circumstances.

5.13. Paragraph (10) provides information on reversionary bonuses. A standardised format has been prescribed and de minimis limits are available.

5.14. Abbreviated reporting requirements apply for an interim valuation made with a view to the distribution of profits or the results of which are made public. In these circumstances the insurer is only required by rule 9.31(a)(ii) to provide Form 58 together with a valuation report which, instead of complying with the requirements of Appendix 9.4, includes a full description of each of the changes in the methods and assumptions used in the investigation for the purposes of rule 9.4(2)(a) and (b) since the previous investigation at the end of the previous financial year or, if there has been no such change, a statement to that effect.

6. Realistic reporting (Forms 18 and 19 and Appendix 9.4A)

6.1. The mathematical reserves reported on Forms 50 to 54 have historically been required to be calculated on a net premium method. Under this method, no explicit provision is made for future discretionary bonuses: rather, a deduction is made from the present value of future premiums to be received on in-force business of the element of the current premium price that relates to the payment of future discretionary bonuses. This was seen by the Regulator as a relatively insensitive adjustment, as it assumed that the current premium fully reflected how future bonuses may be increased, or reduced, in the light of future market circumstances. Another drawback was the sheer complexity of the mathematical reserves rules, which meant that the overall prudence of the end result was not necessarily transparent. With elements of risk-based capital included within mathematical reserves through prudent assumptions, the 4% of mathematical reserves required under the Life Directives (as referred to in paragraph 4.3 of chapter 3) could be seen as a margin on the margin.
6.2. The Regulator’s primary concern was to address the risk that a with-profits firm using the net premium method might fail to keep enough reserves to meet a policyholder’s reasonable expectations that bonuses would increase (if markets improve, and asset values increase). However, this had to be achieved while retaining the mathematical reserves rules (as these were a Directive requirement), and at the same time seeking to avoid worsening the “margin on margin” problem. The solution that the Regulator came up with is sometimes referred to as the “twin peaks” approach. The basic concept is that a with-profits firm to which this basis applies must make two calculations:

1. Mathematical reserves plus solvency requirement
2. A realistic present value of expected future contractual liabilities, plus projected ‘fair’ discretionary bonus payments (together with a risk capital margin to cater for the risk that realistic asset values might be less than expected, or realistic liabilities more than expected, because of a firm’s exposure to market, credit or persistency risk).

Where (2) gives rise to a higher figure than (1), top-up capital (referred to as the with-profits insurance capital component (“WPICC”)) needs to be held.

6.3. The twin peaks approach applies only to a “realistic basis life firm” (long term insurers that are not realistic basis life firms are referred to in this booklet as “regulatory basis life firms”). A realistic basis life firm is defined by the Handbook glossary as a firm to which GENPRU 2.1.18R applies, and which is therefore required to calculate a WPICC under INSPRU 1.3. GENPRU 2.1.18R applies on a mandatory basis to a firm that has with-profits liabilities unless these were less than £500 million at 31 December 2004 and have remained below this level at all times since that date. It is understood, though not explicitly stated in the rules, that this threshold is determined net of reinsurance. When consulting on its proposals the Regulator estimated that this threshold would capture approximately half of firms writing with-profits business, but would cover approximately 95% of the total value of such liabilities. A smaller with-profits office may choose to “opt in” and become a realistic basis life firm by making a formal election to that effect under GENPRU 2.1.20R in accordance with the written notice requirements of SUP 15.7. Such an election might be motivated by a wish to benefit from the relaxations in the regulatory valuation rules available to realistic basis life firms and the abolition of the resilience capital requirement for such firms.

6.4. Under the twin-peaks approach, an insurer is required by INSPRU 1.3.7R to calculate a separate WPICC for each with-profits fund that it maintains. These separate WPICCs (where positive) are aggregated to determine the overall WPICC for the firm, which will be taken to line 37 of Form 2. To calculate a WPICC, the firm must arrive at two values for the fund.

1. Regulatory excess capital, defined by INSPRU 1.3.23R as the excess of the regulatory value of the assets of the fund (under INSPRU 1.3.24R) over the sum of:
   - the regulatory value of the liabilities of the fund under INSPRU 1.3.29R; and
   - the LTICR in respect of the fund’s with-profits insurance contracts.

2. Realistic excess capital, defined by INSPRU 1.3.32R as the excess of the realistic value of assets of the fund (under INSPRU 1.3.33R) over the sum of:
   - the realistic value of liabilities of the fund under INSPRU 1.3.40R; and
   - the risk capital margin for the fund under INSPRU 1.3.43R.

A WPICC arises where 1 exceeds 2.

6.5. Forms 18 and 19 have to be prepared for each with-profits fund. Form 18 shows the derivation of the WPICC, which is arrived at through a comparison between the regulatory
excess capital which is calculated at lines 11 to 49, and realistic excess capital at line 51 which is derived from Form 19. The Instructions to the Form link the elements of regulatory excess capital to the relevant requirements in INSPRU 1.3. The difference between regulatory excess capital and realistic excess capital (which can be an excess or deficiency) is recorded at line 61, and after adjustment at lines 62 and 63 for the difference between the unstressed face amount of capital instruments attributed to the fund and included in capital resources and the realistic stressed amount of such resources, and at lines 64 and 65 for future shareholder and other internal transfers not already taken into account, the WPICC for the fund (which can only be positive or zero) is reached at line 66. The entry for the WPICC at line 37 of Form 2 (where this is completed on a solo basis) represents the sum of total of the amounts for each fund.

6.6. Form 19, which extends over two sheets, provides a realistic balance sheet for a with-profits fund. On the first sheet, lines 11 to 29 report the assets available to the fund (the realistic value of assets and support arrangement assets), and lines 31 to 59 the realistic value of liabilities (with-profits benefit reserve plus future policy related liabilities plus realistic current liabilities). Sheet 2 then incorporates the risk capital margin and additional capital available. The key number, curiously half way down sheet 2 at line 66, is the realistic excess capital for the fund (representing the realistic value of assets available to the fund at line 26 less the sum of realistic value of the liabilities at line 59 and the risk capital margin at line 65). There are extensive Instructions to the Form linking the line entries with the relevant rules in INSPRU 1.3.

6.7. A realistic basis life firm is also required to include an Appendix 9.4A realistic valuation report in its return. This has 14 sections, which should be numbered in accordance with the Appendix, as follows:

1. Introduction - the valuation date, date of the previous valuation and dates of any interim valuations.

2. Assets – the economic assumptions used.

3. With-profits benefits reserve liabilities – a table of the retrospective and prospective methods used.


5. With-profits benefit reserve prospective method – additional prescribed details.

6. Cost of guarantees, options and smoothing – prescribed details including the completion of a table showing the annualised compound equivalent of the risk free rates assumed.

7. Financing costs, where financing arrangements exist.

8. Other long-term insurance business liabilities – the nature and amount of any liabilities relating to the regulatory duty to treat customers fairly and of any other liabilities shown at lines 46 and 47 of Form 19.

9. Realistic current liabilities – the nature and amount of current liabilities shown at line 51 of Form 19 together with a reconciliation to regulatory current liabilities.

10. Risk capital margin, including information relating to the individual scenarios in INSPRU 1.3.44R.

134 Lines 15 and 32 include references to the resilience capital requirement, which is now obsolete for insurers completing this Form. These lines will now always be blank (Instructions 1 and 4).

135 These lines relate to INSPRU 1.3.73R, and only impact on line 66 if the unstressed face amount at line 62 exceeds the realistic stressed amount at line 63.
11. The treatment of tax included on assets backing the with-profits benefit reserve, any future policy-related liabilities and any realistic current liabilities, including any simplifying assumptions.

12. A full description of any major derivative positions held by a with-profits fund or held outside the fund to cover the risk capital margin.

13. A reconciliation of the significant movements in working capital for each with-profits fund as reported in Form 19 line 68 between the previous and current financial years.

14. Optional disclosure for each with-profits fund of the realistic value of liabilities which relate to contractual obligations to policyholders, with a description of the approach taken to distinguishing between contractual and non-contractual obligations to policyholders.

6.8. Under rule 9.3A, a realistic basis life firm is also required to prepare Forms 2, 18 and 19 as at the end of the first six months of the financial year and to submit these to the PRA together with a report identifying any changes to the methods and assumptions used from the Appendix 9.4A realistic valuation report submitted at the end of the previous financial year. There is no audit requirement relating to this submission, but a number of the other rules are applicable, with prescribed modifications, so that, for example, only one signature is required on the directors' certificate. Submission may be by electronic means only, but if a single hard copy is submitted instead this will be sent to the usual supervisory contact and not to the Regulatory Data Group. The directors' certificate that has to accompany the submission is considered in the next chapter.
The present chapter will deal with the requirements of rules 9.34(1) and 9.35 of IPRU(INS) for the return to include a “directors’ certificate” (section 1) and a report by the auditor (section 2). The contents of both of these are prescribed by Appendix 9.6 of IPRU(INS).

1. The directors’ certificate (rule 9.34(1))

1.1. Every return must have attached to it, a certificate signed by designated responsible officers making prescribed statements about matters of which the PRA requires confirmation. This certificate, prescribed by rule 9.34(1), is generally referred to as the “directors’ certificate”, although the signatories need not necessarily all be directors – see chapter 2 paragraph 5.3 for a discussion of the signatories prescribed by rule 9.33. This section sets out a recommended wording for, and provides a commentary on, the heading and paragraphs that the certificate is required to contain. In general terms the paragraphs contain positive statements that certain requirements have been complied with; if these statements cannot truthfully be made they must be omitted, and a note included stating the fact of the omission – it is obviously sensible for this note also to state the reason and any subsequent corrective action taken.

1.2. As stated in chapter 2 paragraph 4.5, it seems desirable to head up the certificate in the same style as is prescribed for the Forms. This would lead to the following format:

“Certificate required by rule 9.34(1) of the Accounts and Statements Rules
Example Insurance plc
Global business/UK branch business/EEA branch business
Financial year ended 31 December 2013
We certify that: …”

If for any reason the “financial year ended” did not appear in the heading, it would be advisable to expand the references to “the financial year” in the body of the certificate. An external direct insurer has to furnish separate certificates with its global and UK branch returns since the prescribed signatories differ.

1.3. Paragraphs (1) and (2) of the certificate will be required for all insurers, but the remaining paragraphs are only relevant to life insurers. The suggested wording is set out below, followed by a paragraph by paragraph commentary.

1. the return has been properly prepared in accordance with the requirements in IPRU(INS), GENPRU and INSPRU.

2. the directors are satisfied that:

(i). throughout the financial year, the insurer has complied in all material respects with the requirements in SYSC and PRIN as well as the provisions of IPRU(INS), GENPRU and INSPRU; and

(ii). it is reasonable to believe that the insurer has continued so to comply subsequently, and will continue so to comply in future.

3. in the directors’ opinion, premiums for contracts of long-term insurance business entered into during the financial year and the resulting income earned are sufficient, under reasonable actuarial methods and assumptions, and taking into account the other financial resources of the insurer that are available for the purpose, to enable

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136 The words “for long-term insurance business” included in the specimen wording do not appear in Appendix 9.6 but have been added in the interests of clarity. As this statement is only required of insurers carrying on long-term insurance business, this appears to be the intended scope of the statement.
the insurer to meet its obligations in respect of those contracts and, in particular, to establish adequate mathematical reserves.

4. the sum of the mathematical reserves and the deposits received from reinsurers as shown in Form 14 constitute proper provision at the end of the financial year for the long-term insurance business liabilities (including all liabilities arising from deposit back arrangements but excluding other liabilities which had fallen due before the end of the financial year) including any increase in those liabilities arising from a distribution of surplus as a result of an actuarial investigation as at that date into the financial condition of the long-term insurance business.

5. the with-profits fund has been managed in accordance with the Principles and Practices of Financial Management as established, maintained and recorded under COBS 20.3.

6. the directors have, in preparing the return, taken and paid due regard to:

   (i). advice from every actuary appointed by the insurer to perform the actuarial function in accordance with SUP 4.3.13R; and

   (ii). advice from every actuary appointed by the insurer to perform the with-profits actuary function in accordance with SUP 4.3.16AR.

1.4. Paragraph (1) is self-evident and non-contentious. However, paragraph (2) of the certificate is a very wide ranging statement. In one sense this is reasonable since there is of course an underlying obligation for an insurer to comply with all the requirements of PRIN, SYSC, GENPRU, INSPRU and IPRU(INS). However, no equivalent statement is required of any other type of PRA-regulated firm. The words “in all material respects” imply that absolute perfection is not required. The requirements would be deemed not to have been satisfied if the insurer commits a breach of any of those obligations which is significant, having regard to the potential financial loss to policyholders or to the insurer, frequency of the breach, implications for the insurer’s systems and controls and if there were any delays in identifying or rectifying the breach. Perhaps the most uncomfortable aspect is the reference point of the statement relating to future compliance, not to specific rules but to the wide ranging requirements of the relevant sections of the Handbook. Fortunately from the point of view of the auditor, the certificate is not within the scope of the auditor’s report.

1.5. In relation to paragraph (3), there is an underlying requirement in INSPRU 1.1.41R for a firm not to enter into a long-term insurance contract unless it is satisfied on reasonable actuarial assumptions that the premiums receivable and the investment income expected to be earned from those premiums and the reinsurance arrangements made in respect of the risk or risks covered by that new contract are sufficient to enable it, when taken together with the firm’s other resources, to:

   ► establish adequate technical provisions as required by INSPRU 1.1.16R;

   ► hold admissible assets of a value at least equal to the amount of the technical provisions as required by INSPRU 1.1.20R to INSPRU 1.1.28R; and

   ► maintain adequate overall financial resources as required by GENPRU 1.2.26R.

It may appear superfluous for the Certificate to require this rule-specific confirmation (paragraph (4) similarly relates to underlying compliance with INSPRU rules), given the wide-ranging certification of compliance required in paragraph (2). The reason may be simply oversight, as some statements were originally required to be made in a separate statement by the appointed actuary and were added to the Certificate when that position was abolished.

1.6. Paragraph (5) stems from the requirement of COBS 20.3.1R for a firm to establish and retain a PPFM in accordance with which the business of its with-profits fund is managed (or, if
appropriate, a separate PPFM for each with-profits fund), and to maintain that record of each version of the PPFM for five years. The “principles” within the PPFM must be enduring statements of the overarching standards the firm adopts in managing its with-profits funds and must describe the business model used by the firm in meeting its duties to with-profits policyholders and in responding to longer-term changes in the business and economic environment. The “practices” within the PPFM must describe the firm’s approach to managing with-profits funds and to responding to changes in the business and economic environment in the shorter term, and be sufficiently detailed for a knowledgeable observer to understand the material risks and rewards from effecting or maintaining a with-profits policy with the firm.

1.7. Paragraph (6) reflects the actuarial responsibilities discussed in chapter 8. The governing body has the overall responsibility for all aspects of the return, but is required to obtain actuarial advice.

1.8. It will be appreciated from the discussion in this section that some adaptation of the wording may be necessary to meet particular circumstances. Where an insurer does not need to include all the prescribed paragraphs it is quite in order to adapt the numbering; thus a life insurer that did not write with-profits business could omit paragraph (5) and number paragraph (6) as (5). Alternatively it could include as paragraph (5) a statement that no with-profits fund is maintained. Such an insurer would only refer in (6) to advice from the holder of the actuarial function.

1.9. A directors’ certificate is required to accompany the submission of the half-yearly balance sheet and report for realistic valuation considered in paragraph 6.8 of chapter 8. Rule 9.34(1) requires an abridged certificate, which only needs to be signed by one director, stating:

► the return has been properly prepared in accordance with the requirements in IPRU(INS), GENPRU and INSINU;

► the amount provided for long-term insurance liabilities for the purpose of determining the insurer’s capital resources as shown in Form 2 constitutes proper provision at the end of the six month period for those liabilities (including all liabilities arising from deposit back arrangements); and

► the directors\(^\text{137}\) have, in preparing the return, taken and paid due regard to:

(i). advice from every actuary appointed by the insurer to perform the actuarial function in accordance with SUP 4.3.13R; and

(ii). advice from every actuary appointed by the insurer to perform the with-profits actuary function in accordance with SUP 4.3.16AR.

As with the annual return certificate, if any statement cannot truthfully be made, it must be omitted, and the fact and reasons for the omission stated in a note to the certificate.

2. The audit of the return (rule 9.35)

2.1. Rule 9.5 requires the accounts and balance sheet of an insurer (including notes, statements and reports annexed thereto) to be audited in accordance with rule 9.35 by a person qualified in accordance with the rules in the Supervision Manual. The requirement for an audit is somewhat anomalous as regulatory returns of other PRA-regulated firms are not routinely subject to audit. The following matters relating to the audit\(^\text{138}\) will be considered here:

\(^{137}\) The IPRU(INS) text refers to “director”, but this seems to be confusing the single prescribed signatory of the certificate with the directors’ collective responsibility for preparing the return.

\(^{138}\) The term ‘audit’ is increasingly used only to refer to an independent auditor’s examination of and report on a set of general purpose financial statements, however the auditor’s examination of and report on the return according to
Chapter 9 – Directors’ certificate and auditor’s report

► who may act as auditor (paragraph 2.3)
► which documents are subject to audit (paragraph 2.4)
► the need to obtain advice from an independent actuary (paragraph 2.6)
► the nature of the opinion expressed on these documents (paragraphs 2.7 to 2.14).

2.2. The auditor may in certain circumstances need to report directly to the PRA or to the FCA; this topic is addressed in paragraphs 2.15 onwards.

2.3. Chapter 3 of the Supervision Manual requires the auditor to be a person who is eligible for appointment as a company auditor under Chapters 1, 2 and 6 of Part 42 of the Companies Act 2006 or, in the case of an overseas firm, is eligible for appointment as an auditor under any equivalent laws of that country or territory. The UK requirement implies both a positive qualification and an absence of any specific disqualification. The positive qualification required is membership of a recognised supervisory body and eligibility for appointment under the rules of that body. The disqualifications are designed to secure the independence of the auditor. A person may not act as auditor if he is:

(a) an officer (e.g. director, manager or secretary) or employee of the insurer;
(b) a partner or employee of such a person, or a partnership of which such person is a partner; or
(c) ineligible by virtue of (a) or (b) for appointment as company auditor of any associated undertaking of the insurer; or if
(d) there exists between the person or an associate of his and the insurer or an associated undertaking of the insurer a connection of such description as may be specified by Regulations set out by the Secretary of State.

These disqualifications are contained in section 1214 of the Companies Act 2006. The ethical guides of the professional bodies prescribe additional circumstances where a member should not accept an appointment as auditor because of conflicts of interest.

2.4. The documents subject to audit are specified by rule 9.35, and comprise the following, including any supplementary notes relating to them:

► Forms 1 to 3 and 10 to 19 (i.e. all the Forms in Appendix 9.1)
► Forms 20A and 20 to 39 (i.e. all the Forms in Appendix 9.2)
► Forms 40 to 45, 48, 49, 56, 58 and 60 (i.e. certain of the Forms in Appendix 9.3)
► the statements of major reinsurers and cedants prepared under rules 9.25 to 9.27
► the statement of additional information on derivative contracts prepared under rule 9.29
► the valuation report (Appendix 9.4) and the realistic valuation report (Appendix 9.4A) required by rule 9.31.

The scope set in the rules is termed an audit by the rules and consequently the term is used in the broader sense in this booklet.
2.5. As will be clear from the above, not all of the return has to be audited. The documents outside the scope of the audit fall into the following categories:

► information about general insurance business reinsurance arrangements required by rule 9.32 and Appendix 9.5
► information about financial reinsurance arrangements and financing arrangements required by rule 9.32A
► information about controllers required by rule 9.30
► Forms 46, 47, 50 to 55, 57, 59A and 59B within Appendix 9.3
► the information on the actuary appointed to perform the with-profits actuary function required by rule 9.36
► the directors’ certificate.

2.6. Rule 9.35(1A) requires the auditor of a long-term business insurer to obtain and pay due regard to advice from a suitably qualified actuary who is independent of the insurer in respect of any amounts or information abstracted from the actuarial investigation performed under rule 9.4 which are included in the documents subject to audit. This actuary does not necessarily need to be independent of the auditor, and could therefore be an employee of the auditing firm. This independent actuarial involvement is intended to ensure that the actuarial work on the determination of liabilities receives an adequate challenge.

2.7. In the opinion that an auditor expresses on a set of financial statements, the auditor will normally state *inter alia*:

(a) that the financial statements give a true and fair view of the state of affairs and result for the year; and

(b) that the financial statements comply with the provisions of the relevant legislation.

2.8. At first sight the opinion expressed on the return (see appendix C for a specimen wording) seems to be of a rather different character. Leaving aside for the moment exclusions and disclaimers, the auditor is stating:

1. that the Forms (including the supplementary notes) and statements subject to audit have been properly prepared in accordance with the Accounts and Statements Rules; and

2. (in the case of a long-term insurer) that the methods and assumptions used to perform the actuarial investigation (as set out in the valuation reports) appropriately reflect the requirements of INSPRU 1.2 and 1.3.

2.9. At least in terms of part (1) of this opinion, the auditor appears only to be stating something equivalent to part (b) of the “normal” report, since there is no reference to a true and fair view. However, compliance with the Accounts and Statements Rules necessitates that the requirements of rule 9.11 are satisfied, and this specifies that all documents prepared under rule 9.3(1), (2) and (3) “must be prepared in the manner specified by the Accounts and Statements Rules and must fairly state the information provided on the basis required by the Accounts and Statements Rules”. It is therefore implicit in an unqualified audit opinion that the information is fairly stated on the basis required. This is a slightly different criterion from the true and fair view of the “normal” report. However, although different, it does not in any sense represent a lesser standard or indicate a different approach by the auditor. The concept of materiality is therefore applicable in arriving at the figures reported, although not in respect of the figures that are required to agree from one cell to another. The repealed Guidance Note 9.1 stressed that “materiality” was not an acceptable excuse for the
deliberate or reckless misstatement or omission of information required to be disclosed by the Rules, nor did it justify a lack of proper care in the preparation of such information.

2.10. Rule 9.35 applies with certain modifications the requirements of sections 498(1) to (3), 499(1) and 500(1) of the Companies Act 2006 to the audit of the return. The effect of these is as follows:

► Section 498(1) requires the auditor to investigate whether:

(i). adequate accounting records have been kept;

(ii). returns adequate for the audit have been received from branches not visited; and

(iii). the accounts are in agreement with the accounting records and returns.

► If the auditor is not satisfied on any of these matters, the auditor is required by section 498(2) to state the fact in the report.

► Section 499(1) gives the auditor unlimited right of access to the accounting records and entitles the auditor to require from the officers of the insurer and of any subsidiary undertaking of the insurer incorporated in the United Kingdom such information and explanations as the auditor considers necessary.

► Section 500(1) imposes a duty on the insurer to take all such steps as are reasonably open to it to obtain information required by the auditor from any subsidiary undertaking of the insurer not incorporated in the United Kingdom.

► Section 498(3) requires the auditor to state in the report that the auditor has failed to obtain all necessary information and explanations, if such is the case.

2.11. The absence of any reference to the matters covered by section 498 in the auditor’s report therefore implies that the auditor was satisfied on these matters.

2.12. Where an independent opinion is expressed, there is always the possibility that the opinion will be an adverse one. If the auditor considers that the Forms or statements have not been properly prepared in accordance with the Accounts and Statements Rules and cannot persuade the insurer to make the necessary changes, a qualified audit report will be necessary. A qualification is effected by the inclusion of an additional paragraph within the ‘basis of opinion’ section of the report, setting out the matters on which the auditor is not satisfied and prefacing the ‘opinion’ section of the report with appropriate words. While it is possible for the opinion on the accounts to be qualified whilst that on the return is unqualified, and vice versa, this will normally be restricted to situations where the grounds for qualification relate to the treatment of a particular item (e.g. if an asset is included in the return at a value which does not take account of the specific requirements of the valuation rules). In most cases any qualification (e.g. in relation to the level of technical provisions) would be expected to be a feature of both opinions.

2.13. Guidance from the auditing profession is clear that professional auditing standards (currently, ISA (UK and Ireland) 700) apply to the opinion expressed on the return and that a long form report setting out the respective responsibilities of the insurer and its auditor and the basis of the auditor’s opinion is therefore necessary. Detailed guidance is provided by Practice Note 20 “The audit of insurers in the United Kingdom”, most recently revised in January 2011.

2.14. A number of auditors’ reports have over the years, following the profession’s guidance, included fundamental uncertainty paragraphs. Where an inherent uncertainty exists which in the auditor’s opinion is fundamental but which is adequately accounted for and disclosed in the financial statements being reported on, the auditor is required to include an explanatory paragraph referring to the fundamental uncertainty in the section of the report setting out the basis of opinion. When adding such a paragraph, the auditor will use words which clearly
indicate that his opinion on the financial statements is not qualified in respect of its contents. Doubtless as a result of the appearance of such paragraphs in auditors’ reports on the returns of various insurers, paragraph 12 of Appendix 9.6 requires auditors referring to any uncertainty to state in their report whether that uncertainty is material to determining whether the insurer has available assets in excess of its capital resources requirement. The repealed Guidance Note 9.1 indicated that the FSA expected an uncertainty to be treated as material for these purposes if, upon the crystallisation of so much of the uncertainty as is not remote, the required level of available assets would not be met.

2.15. Auditors of insurers and other firms in the financial services sector have for many years had a statutory right (and, since 1994, duty) to report directly to the Regulator under prescribed circumstances. The relevant provisions are set out in the Financial Services and Markets Act 2000 (Communications by Auditors) Regulations 2001 (2001 No. 2587). The grounds that trigger the duty prescribed by these Regulations are as follows:

► The auditor reasonably believes that, as regards the insurer:

- there is or has been, or may be or may have been, a contravention of any relevant requirement that applies to the insurer; and

- that contravention may be of material significance to the PRA, the FCA or the Bank of England in determining whether, in relation to the insurer, any functions conferred on that body by or under any provision of the Act other than Part 6 (the Part relating to Official Listing);

► The auditor reasonably believes that the information on, or the auditor’s opinion on, those matters may be of material significance to the PRA, the FCA or the Bank of England in determining whether the insurer satisfies and will continue to satisfy the threshold conditions (as described at in section 6 of chapter 1);

► The auditor reasonably believes that the insurer is not, may not be or may cease to be a going concern;

► The auditor is precluded from stating in the report that the annual accounts or other financial reports of the insurer have been properly prepared in accordance with the Companies Act 2006 or, where applicable, give a true and fair view of the matters referred to in section 459(3)(a) of that Act or been prepared so as to conform with the requirements of rules made under FSMA where the auditor is, by rules made under section 340 of FSMA, required to make such a statement; or

► Where applicable, the auditor is required to state in the report in relation to the person concerned any of the facts referred to in subsection (2), (3) or (5) of section 498 of the Companies Act 2006.

2.16. Section B of ISA (UK and Ireland) 250 “The auditor’s right and duty to report to regulators in the financial sector” summarises generically the right and duty to initiate direct reports to regulators in the financial services sector. It has been supplemented by guidance developed for each type of regulated entity. In the case of insurers, the relevant guidance is contained in Practice Note 20. The scope of the right to report is extremely broad in that it provides protection to auditors in relation to a wide range of communications provided that they act in good faith, since it applies to any matters obtained in the capacity of auditor of an insurer that is relevant to the Regulators’ functions and there is no reference to materiality. In contrast, the statutory duty is much narrower in scope but seems likely to trigger the majority of reports that will be made to a Regulator since the grounds for doing so cover most cases where auditors’ concerns are likely to be aroused. The Regulator has historically accorded particular importance to timely notification of matters giving rise to the duty to report.

2.17. Following a period of discussion, the FSA published in May 2011 a Code of Practice for the relationship between the external auditor and the supervisor. This had the status of guidance under section 157 of FSMA. The Code of Practice relates to the broader audit relationship
rather than just the audit of the return, and as such is described only briefly here, but the Code sets out four principles to govern the relationship, being as follows:

► Supervisors and auditors shall seek an open, cooperative and constructive relationship;

► Supervisors and auditors should engage in regular dialogue;

► Supervisors and auditors shall share all information relevant to carrying out their respective statutory duties in a timely fashion; and

► Supervisors and auditors shall respect their duty to treat information shared between the two parties or received from firms confidentially.

An Annex to the Code contemplates, in the case of a firm classified as very high impact, periodic meetings between the FSA and the firm’s auditors, aligned to the phasing of the firm’s audit and focusing on the key issues and judgements within the audit scope.

2.18. Following legal cutover, the PRA adopted with some revisions, and issued as Supervisory Statement LSS7/13, the Code originally issued by the FSA, including the Annex on bilateral meetings which is stated to be applicable to Category 1 firms of which the PRA is the home supervisor. The FCA also issued, as Finalised guidance FG13/03, its own revision of the Code, in which it reordered the four principles of the FSA’s Code and added a fifth, being the auditor’s duty to report (though this additional principle appears simply to state the auditor’s responsibility).
Chapter 10 – Groups

This chapter provides a brief description of the relevant European Directives underlying the UK’s rules on insurance groups, proceeding at section 2 to describe how an insurer that is a parent prepares its ‘adjusted solo’ return, and at section 3 to discuss the Group Capital Adequacy Report that is required of insurers that are members of insurance groups. Section 4 briefly discusses financial conglomerate reporting.


1.1. Insurance regulation concentrates primarily upon the legal entity entering into the insurance contract and seeks to ensure that this entity is able to meet its commitments on a standalone basis. However, it has been increasingly recognised by regulators that there are additional concerns to be addressed where an insurer is a member of a group, as problems arising elsewhere in the group can impact on the viability of the insurer. Such concerns are explicitly recognised within the threshold conditions in Schedule 6 to FSMA, in that:

- Paragraph 4D requires an insurer’s business to be conducted in a prudent manner in assessing which it is relevant to consider inter alia the insurer’s membership of a group and any effect that membership may have.

- Paragraph 4F requires an insurer to be capable of being effectively supervised by the PRA, according to a number of criteria. These include that, where the insurer is a member of a group, neither its membership of the group nor the existence of ‘close links’ with other persons (which will always exist when an insurer is a member of a group) is likely to prevent effective supervision of the insurer by the PRA.

1.2. SYSC 12 and INSPRU 6.1 provide an articulation of what the PRA considers necessary for an insurer, both in respect of systems and controls and financial condition, in the context of these high level conditions. These are also the means by which the provisions of the EU Insurance Groups Directive (“IGD”) and Financial Groups Directive (“FICOD”) are implemented in the UK. This section will consider the background to these Directives and the way in which they have been implemented in the UK. The detailed requirements of the two calculations which result from the IGD – the adjusted solo calculation (prepared where an insurer is a participating insurance undertaking) and the group capital adequacy report or GCAR (prepared where a UK insurer is a subsidiary of an insurance parent undertaking) - will be considered in sections 2 and 3 respectively, and financial conglomerate reporting in section 4. Disclosure requirements for material connected-party transactions are considered in section 1 of chapter 11.

1.3. The main obligations arising under the IGD are for member States to require:

- an adjustment to the solo solvency test in relation to participating interests in other insurance undertakings;

- a parent undertaking solvency calculation;\(^{139}\) and

- rules as to internal controls within the insurance undertaking regarding the production of information relevant to supplementary supervision, the exchange of information within the group and the supervision of intra-group transactions;

- co-operation between competent regulatory authorities of member States.

1.4. FICOD requires additional prudential supervision for groups which significantly straddle the insurance and investment/banking sectors and which are referred to as financial conglomerates.

\(^{139}\) Now reported in the GCAR.
conglomerates. FICOD amended the sectoral groups directives with a view to achieving this, as well as including additional specific provisions, though as was subsequently recognised, the logic of the provisions meant that some conglomerates were subject to lower intensity of additional supervision due to their structure. FICOD1 (see below) sought to amend this situation.

1.5. A full discussion of what constitutes a financial conglomerate is beyond the scope of this booklet, but a brief description follows. A financial conglomerate is deemed to arise where all of the following conditions (which appear as Annex 4R to GENPRU 3) are satisfied. A “financial sector” represents for the purpose of these tests (1) the insurance sector, and (2) the banking and investment services sectors combined, the two together forming the “overall financial sector”.

- At least one of the members in the consolidation group is within each financial sector.

- Either:
  - An EEA-regulated entity is at the head of the consolidation group and is a parent undertaking of a member of the consolidation group in the overall financial sector, has a participation in a member of the consolidation group that is in the overall financial sector, or has a consolidation Article 12(1) relationship with a member of the consolidation group that is in the overall financial sector.
  - At least one of the subsidiary undertakings in the consolidation group is an EEA-regulated entity, and the ratio of the balance sheet total of the members of the consolidation group in the overall financial sector to the balance sheet total of the whole consolidation group as a whole exceeds 40%.

- Either:
  - For each financial sector, the average of the ratio of the balance sheet total of that financial sector to the balance sheet total of the overall financial sector, and the ratio of the solvency and capital adequacy requirements to the total solvency and capital requirements of members in the overall financial sector exceeds 10%.
  - The balance sheet total of the smaller financial sector exceeds €6 billion.

1.6. Any insurer that is a member of a group is required by SUP 15.9.2R to establish whether any group of which it is a member is or has ceased to be a financial conglomerate, if it is reasonable to believe that is likely. If the insurer establishes either that a group is a conglomerate or that it has ceased to be one, it must notify the PRA of the fact (SUP 15.9.1R) unless the group is already being regulated as a conglomerate or the notification has already been made (to the PRA or to another EEA member state’s regulator which is designated as the co-ordinating supervisor of the conglomerate). SUP 15.9.3G explains that firms should consider these matters on an ongoing basis but particularly when the consolidated financial statements are prepared and whenever an event occurs (such as a merger or acquisition) that affects the consolidated group.

1.7. Where a financial conglomerate exists, a variety of obligations are triggered, including conglomerate capital adequacy requirements, systems and controls requirements for the monitoring of intra-group exposures and risk concentrations across sectors and the appointment of a single supervisory co-ordinator in the EEA with defined obligations.

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140 There is a degree of regulatory discretion to disapply the absolute test if the relative test is not exceeded; FICOD1 added further discretion where the relative but not the absolute threshold is met.
1.8. The FSA originally estimated (in CP 204) that there were likely to be between ten and thirty UK financial conglomerate groups, depending upon how regulatory discretion was applied in practice. The actual number of UK groups designated as conglomerates has actually been far smaller than this – the list of financial conglomerates published by the Joint Committee of the European financial super-regulators identifies only eight UK-headed groups based on end 2012 figures, and of these four were not subject to full supervision as such. The remaining four were Baillie Gifford & Co., Lloyds Banking Group, Old Mutual and Co-Operative Banking Group Limited (though a further four third-country conglomerates have the PRA or FCA identified as the potential EU co-ordinating supervisor, or which three are subject to full supervision).

1.9. The FICOD requirements are reflected in the Handbook in GENPRU 3.1 and 3.2. The reporting requirements are set out in SUP 16.12, and are considered further in section 4.

1.10. A new Directive, FICOD1, amended FICOD (and the sectoral Groups Directives and indeed Solvency II) in 2011 and had mostly to be implemented by 10 June 2013. The intention of FICOD1 was, drawing lessons from the financial crisis, to equip supervisors better to oversee the parent entities of conglomerates. In particular, it was felt that the interplay of FICOD with the IGD and the Capital Requirements Directive (for the banking sector) had left unintended gaps in the powers of supervisors over mixed financial groups headed by holding companies rather than by insurance undertakings or financial institutions, and such groups were consequently not subject to the more rigorous sectoral group supervision requirements. This anomaly was removed by FICOD1. The changes as implemented in the UK may be summarised as follows:

► Application of supplementary supervision at holding company level;

► Inclusion of asset management companies and alternative investment fund managers in the threshold calculations to identify financial conglomerates;

► New waiver provisions to allow exclusion of small groups from mandatory designation as financial conglomerates;

► New ability to disregard participations that are decisive in identifying a conglomerate but are of negligible supervisory interest;

► New requirement for conglomerates to report details of their legal and organisational structures;

► Application of stress testing requirements to financial conglomerates;

► Amendment to the methods permitted for calculating conglomerate group solvency; and

► Changes to conglomerate capital adequacy reporting.

1.11. Of these changes, which were consulted on by the FSA in CP 12/40 and made by the Financial Conglomerates Directive (Handbook Amendments) Instrument 2013 (Legal Instrument PRA 2013/22), the first is of considerable interest. It brought groups headed by mixed financial holding companies, in which insurance was not the most important financial sector, within the scope of INSINU 6.1. Conglomerates dominated by insurance were already within scope, but all conglomerates headed by mixed financial holding companies (referred to in the Handbook as ‘MFHC conglomerates’) are now added. Insurance groups and MFHC conglomerates remain mutually exclusive (a mixed financial holding company


142 It remains unclear why insurance groups rules should, by default, apply to a banking conglomerate that is headed by a mixed financial holding company but not to one that is headed by a bank.
cannot be an insurance parent undertaking) so an MFHC conglomerate may include one or more insurance groups to which INSPRU 6.1 must also be applied.\footnote{143}

1.12. In its Policy Statement PS 3/13 in May 2013, the PRA stated that its intention in extending supplementary supervision to MFHC conglomerates was to counter the situation where a holding company to which sectoral rules would have applied becomes a mixed financial holding company, potentially displacing those sectoral rules. The PRA states that, where the application at the level of both the ultimate EEA mixed financial holding company and the ultimate EEA insurance parent undertaking results in duplication, it intends to consider waiver. INSPRU 6.1.5AG has been introduced to state this (and extends also to the worldwide group level, not just the EEA group level). It should be noted that it remains part of the definition of mixed financial holding company that the group that it heads has been notified by the coordinating supervisor both that it is a financial conglomerate, and that discretion not to treat it as a financial conglomerate has not been exercised. If these conditions are not met, then the parent may still constitute an insurance holding company and the group an insurance group.

1.13. Article 5 of FICOD\(^1\) required the Commission to report to the European Parliament and the Council by 31 December 2012 on its review of FICOD. This report (Commission document COM(2012) 785) was published on 20 December 2012. The report concluded that some areas of supplementary supervision of financial conglomerates could be improved, but noted that revisions were already in train in both the banking and investment and insurance sectors that would address some of these matters. In addition work was ongoing on a global basis, under the aegis of the G-20 group of industrialised nations, to address risks posed by systemically important financial institutions (for example, by imposing requirements for recovery and resolution planning, so-called “living wills”). The supervisory process was also facing revision as a consequence of the proposed Eurozone banking union. The report concluded in effect that there was too much going on in the financial services regulatory landscape to warrant further specific change to FICOD in the short term, but that the matters identified in the report would be kept under review and a revision would be proposed at an appropriate time.

2. **The adjusted solo solvency calculation (Forms 1, 2 and 3)**

2.1. In the Handbook, both the valuation of investments in other insurers (and other financial institutions) and the determination of group capital adequacy at parent level are dealt with in INSPRU 6.1. This section of the Handbook expresses both areas in terms of the maintenance of group capital resources at least equal to the group capital resources requirement (“GCRR”). Whilst it is understandable that the Regulator wishes to stress the similarity of the process that needed to be carried out in the two circumstances, the approach results in an unnecessary degree of complexity in the formulation of the rules and consequently to the way they are reflected in the Accounts and Statements Rules in IPRU(INS).

2.2. The outcome in terms of the annual return is that Forms 1, 2 and 3 are completed by a participating insurance undertaking in a different way from that described in chapter 3, in order to provide the required comparison between group capital resources and the GCRR (an approach which will be referred to as an “adjusted solo” basis), but all the subsequent Forms are prepared on a pure solo basis as previously. The main difference between the solo and the adjusted solo approaches relates to the treatment of the individual CRR of a regulated related undertaking: whereas on a solo basis (and therefore in all cases on Form 13) this is offset against the regulated related undertaking’s capital resources after deductions in arriving at the regulatory carrying value, on an adjusted solo basis this is aggregated with the insurer’s own individual CRR in order to arrive at the GCRR reported on Form 1 or 2. This may be thought of as a grossing up exercise, as both the resources and the requirement will be increased, in comparison with the solo approach, by the sum of all regulated related undertakings’ individual CRRs. The absolute difference between resources

143 It is unclear whether this was the intention of the rules and an insurer apparently faced with multiple levels of reporting may wish to discuss the matter with its supervisor.
and requirement may be the same, but the extent of coverage of the requirement will appear to be lower in relative terms as a result of the higher denominator.\textsuperscript{144}

2.3. An adjusted solo calculation is required if the insurer is a "participating insurance undertaking", which is defined by the Handbook glossary as an insurer which:

(a) has a subsidiary undertaking that is an insurance undertaking;

(b) holds a participation in an insurance undertaking; or

(c) is linked to an insurance undertaking by a consolidation Article 12(1) relationship.

2.4. The impact of FICOD on the annual return depends upon whether the insurer is a participating insurance undertaking, as the possession of a participation in a financial undertaking is not sufficient to make an insurer a participating insurance undertaking. An insurer that is outside the definition of a participating insurance undertaking but which has a banking subsidiary would still complete its Forms 1 to 3 on a solo basis and deal with the bank’s individual CRR as a deduction in arriving at capital resources (on Form 3, this would be dealt with as part of the deductions for regulated non-insurance related undertakings at line 76): somewhat paradoxically, if it has both a banking subsidiary and an insurance subsidiary it will incorporate the banking subsidiary in the adjusted solo calculation and treat the bank’s individual CRR as part of the GCRR.

2.5. The fundamental adjusted solo requirement of INSPRU 6.1.9R is for the insurer to maintain at all times tier one and tier two capital resources of such an amount that its group capital resources are greater than or equal to its GCRR. Provided that this requirement is satisfied, the insurer is deemed to be in compliance with GENPRU 2.1.13R, and does not need to complete Forms 1, 2 and 3 on a pure solo basis in order to demonstrate that it has complied with GENPRU 2.1.13R.\textsuperscript{145} Where the insurer is itself a composite, it will have to calculate separately the GCRR for general insurance business and long-term insurance business and allocate its group capital resources between general insurance business and long-term insurance business such that both requirements are satisfied, completing both Form 1 and Form 2. If, however, the insurer only carries on general insurance business but has a subsidiary that carries on long-term insurance business, there will only be one GCRR and only Form 1 will be completed (or similarly only Form 2 if the insurer only carries on long-term insurance business but has a subsidiary that carries on general insurance business).

2.6. The GCRR is the more straightforward of the two elements on INSPRU 6.1.9R to comprehend. This is defined by INSPRU 6.1.33R as the sum of the individual CRRs of the insurer and each of its regulated related undertakings. INSPRU 6.1.28R applies a proportionality principle where the related undertaking is not a wholly-owned subsidiary and provides that only the relevant proportion of the individual CRR and solo capital resources of that undertaking are to be taken into account, unless there is a deficit in a subsidiary that is a regulated related undertaking, in which case the full deficit is to be recognised, rather than the proportionate share. The insurer will compute its individual GICR or LTICR on Forms 11, 12 and 60 in the normal way. The GICR or LTICR appears at line 31 in the normal way, and the individual MCR at line 34 after inclusion of the resilience capital requirement at line 32 (Form 2 only) and comparison with the base capital resources requirement at line 33. The line 34 individual minimum capital requirement is then aggregated with the capital resources requirement of regulated related undertakings at line 35 in order to arrive at the line 36 minimum capital requirement for the group. In a sense the calculation is worked out backwards, as the Instructions to the Form require line 36 to be the amount represented by (R-S) with reference to INSPRU 6.1.45R and line 35 is required to represent the difference

\textsuperscript{144} For example, if insurer A has net admissible assets of 200 and an individual CRR of 100, a solo return would indicate 200% coverage of the CRR. However, if the admissible assets include an investment in a wholly-owned subsidiary insurer B which has a regulatory carrying value of 60, based on net admissible assets of 120 and an individual CRR of 60, the adjusted solo calculation will report group capital resources of 260 and a GCRR of 160, which would indicate 162.5% coverage of the GCRR.

\textsuperscript{145} A return will therefore include these Forms completed either on a solo basis or on an adjusted solo basis but not both.
between line 34 and line 36. However, line 35 should be objectively provable by reference to the Form 13 reconciliation and supplementary note 0301.\(^{146}\)

2.7. The individual CRR for each regulated related undertaking is determined in accordance with INSPRU 6.1.34R. For a PRA-regulated direct insurer, this will simply be its CRR determined in accordance with GENPRU 2.1, subject to the elimination of any double counting of the WPICC within this requirement and the CRR of the insurer performing the adjusted solo calculation (this would only occur if both the insurer and a regulated related undertaking were both realistic basis life firms). For other regulated related undertakings, the considerations vary. Some of the prescribed treatments are based on the concept of a proxy CRR, which is defined by the Handbook glossary as the MCR to which the undertaking would have been subject if it had held Part 4A permission in respect of each regulated activity that it carries on anywhere in the world. Several separate situations are identified by INSPRU 6.1.34R: the key features of the varying treatments may be summarised as follows.

► If the undertaking’s head office is in another EEA State, that State’s regulatory rules (for the relevant sector if the entity is not an insurer) will be applied.

► If the undertaking is an insurer with its head office in a designated State or territory\(^{147}\) outside the EEA, either the solo CRR under local rules or the proxy CRR can be used (parallel provisions for regulated related undertakings that are banking and investment undertakings are provided by paragraphs 6.5 and 6.6 of GENPRU 3 Annex 1R).

► If the undertaking is an insurer whose head office is not in a designated state or territory, the proxy CRR will be used. One consequence of the definition of ‘designated state or territory’ is that group members who are corporate members of Lloyd’s need to be assessed under the rules for insurance companies rather than those of the Lloyd’s market.

A regulated related undertaking in the banking or investment services sector that is not actually a regulated undertaking (somewhat counter-intuitively, not all entities falling within the definition of “regulated related undertaking” are necessarily regulated, and some entities that are regulated, such as insurance brokers, do not fall within the definition) is treated as being in the investment services sector if it is an asset management company and as in the banking sector if it is a financial institution. Both terms are defined and refer back to European Directives. It would be prudent for an insurer to check the status under these definitions of any group undertaking carrying out financial activities, to ensure correct classification and where necessary inclusion in the calculation.

2.8. Having calculated the GCRR, this figure can be entered directly at line 41 of Form 1 or 2 as appropriate (only if the insurer is itself a composite will both be prepared; the investments in regulated related undertakings will be reflected on the Form for the type of business for which they represent investments). The MCR quoted at line 36 will be arrived at by deducting the sum of all the WPICCs within the GCRR from the line 41 figure. If the calculation is being performed on Form 2, the WPICCs (those of the insurer and of its regulated related undertakings) will be entered at line 39. However if the calculation is being prepared on Form 1 (i.e. a regulated related undertaking with a WPICC is owned by a general insurer or as an investment of the general insurance business of a composite insurer) there is nowhere to show the related undertaking’s WPICC on the Form, and the WPICC will be a reconciling difference between lines 36 and 41. Whilst this does not seem an intuitive result, it is what the Instructions to the two Forms require.

2.9. Equivalents to the three supplementary GENPRU tests discussed in relation to solo solvency in chapter 3 are prescribed by INSPRU 6.1.45R, and will be reflected on the Forms. The calculations at lines 37 and 38 are straightforward enough, as these are based on 50% and

\(^{146}\) Reference to supplementary notes 1403 and 1504 may also be necessary in the event of a deficit.

\(^{147}\) Defined by the Handbook glossary as any EEA State (other than the United Kingdom), Australia, Canada (or a province of Canada), Hong Kong, Singapore, South Africa, Switzerland, a State in the United States of America, the District of Columbia or Puerto Rico.
75% respectively of the line 36 MCR in precisely the same way as when the Form is prepared on a solo basis. However, the guarantee fund requirement at line 21 is required by the Instructions to the Form to be arrived at by applying the formula “⅓X + (R – S – U - X)” which corresponds to the requirement in INSPRU 6.1.45R(2). In this formula “X” represents the MCR of the insurer preparing the return less its resilience capital requirement, and the ⅓X therefore corresponds to the guarantee fund that the firm would have been required to maintain on a solo basis. R – S is the group MCR (i.e. the figure at line 36), while U represents the sum of the resilience capital requirements. The overall requirement therefore equates to ⅓ of the insurer’s GICR or LTICR plus 100% of the GICR or LTICR of its regulated related undertakings. The rationale for this appears to be that the guarantee fund has to be considered on a solo basis, and having recognised the capital covering the GICR or LTCR of its regulated related undertakings in the GCRR, it is necessary to add it to the guarantee fund in order to achieve the correct result.

2.10. The group capital resources are calculated on the basis of the table in INSPRU 6.1.43R, which is the group/adjusted solo equivalent of the solo capital resources table in GENPRU 2 Annex 1R that was considered in chapter 3. By virtue of INSPRU 6.1.37R, references in INSPRU 6.1 to tier one, tier two, upper tier one, upper tier two and innovative tier one capital resources and to core tier one capital are to be construed by reference to GENPRU 2 Annex 1R but with such adjustments as are necessary to ensure that the calculation for a regulated related undertaking that is not an insurance undertaking complies with the relevant sectoral rules. The table, and the relevant lines on Form 3 when this is completed on an adjusted solo basis, are as follows.

| A | Total group tier one capital – line 39 |
| B | Total group tier two capital – line 69 |
| C | Group capital resources before deductions (A – B) – line 72 |
| D | Total deductions of inadmissible assets – line 73 |
| E | Total deductions under the requirement deduction method from capital resources – line 75 |
| F | Total deductions of ineligible surplus capital – line 77 |
| G | Deductions of assets in excess of market risks and counterparty limits – line 74 |
| H | Group capital resources (C – (D + E + F + G)) – line 79 |

Limitations on the use of particular types of capital are imposed at the group level by INSPRU 6.1.45R, which places restrictions, corresponding to those that apply on a solo basis, on the credit that can be taken for non-core tier one capital, innovative tier one capital, tier two capital and lower tier two capital, and impose the supplementary tests referred to in the previous paragraph in respect of the group capital resources that are eligible to cover the guarantee fund and 50% and 75% of the group MCR.

2.11. The methodology to be applied is most easily explained by describing the process to be undertaken in completing Form 3 on an adjusted solo basis. Instructions 33 to 57 to the Form apply in these circumstances. The key features of the approach, some aspects of which will be elucidated in subsequent paragraphs, are as follows.

Many of the lines on the Form (11 to 15, 21, 22, 25, 27, 32 to 35, 45, 46, 51 and 52), are populated with the insurer’s solo figures – in effect the same numbers that would have been reported if the Form had been completed on a solo rather than an adjusted solo basis. This means that prior to the subsequent adjustments, the Form

\textsuperscript{148} Assuming that the base capital resources requirement is not higher than one third of the GICR or LTICR, which is extremely unlikely for a participating insurance undertaking.
will reflect the book value of investments by the insurer in its regulated related undertakings.

- Entries are made at lines 16, 23, 26, 28, 47 and 53 (which will only contain figures when the Form is completed on an adjusted solo basis) to reflect the effect on the group capital resources of the individual capital resources of regulated related undertakings. In effect this is adding or subtracting the differences between the book value of the insurer's investment in the relevant capital resources and the value of those capital resources determined on a GENPRU basis.

- Lines 42 and 43, dealing with perpetual non-cumulative preference shares and innovative tier one capital excluded from tier one because of the limits, will despite the words that appear on the face of the Form (which refer specifically to lines 25 and 27), include any amounts in respect of regulated related undertakings which have been excluded from lines 26 and 28. Where amounts excluded from lines 26 and 28 have been included at lines 42 and 43, Instruction 38 requires the amounts to be stated in a supplementary note (code 0304).

- An entry is made at line 36 for deductions from tier one capital in related regulated undertakings (i.e. investments in own shares, intangible assets, discounting adjustments and other negative valuation adjustments in such undertakings) and at line 77 for total ineligible surplus capital. Again, these lines will only contain figures when the Form is completed on an adjusted solo basis.

- Lines 71 and 76 only apply on a solo basis and will therefore be left blank when the Form is completed on an adjusted solo basis.

- Lines 73 and 74 will be completed to show the effect on the group of inadmissible assets and the market risk and counterparty limits, and line 75 to show the effect of adjustments for investments in ancillary services undertakings.

- The mechanics for calculating the capital resources qualifying for the supplementary tests at lines 81, 82 and 83 are the same as for the solo Form.

- The financial engineering adjustments at lines 91 to 96 are calculated only by reference to the insurer.

2.12. The concept of comparison between book value and the underlying capital resources is key to the completion of the Form, and is not dissimilar to the “look through” approach that is applied in valuing investments in regulated related undertakings for the purpose of Form 13, save that the underlying regulatory capital requirement is not deducted. The following straightforward example should make the concept clear. General insurer A owns 100% of the shares in general insurer B, which it carries in its books at £50 million. B has prepared its own PRA return, which reports the following figures.

<table>
<thead>
<tr>
<th>£000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Permanent share capital (line 11)</td>
</tr>
<tr>
<td>Profit and loss account and other reserves (line 12)</td>
</tr>
<tr>
<td>Total tier one capital before deductions (line 31)</td>
</tr>
<tr>
<td>Amounts deducted from technical provisions for discounting (line 33)</td>
</tr>
<tr>
<td>Total tier one capital after deductions (line 39)</td>
</tr>
<tr>
<td>Total tier two capital (line 69)</td>
</tr>
<tr>
<td>Total capital resources before deductions (line 72)</td>
</tr>
<tr>
<td>Inadmissible assets (line 73)</td>
</tr>
</tbody>
</table>
Chapter 10 – Groups

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets in excess of market risk and counterparty limits (line 74)</td>
<td>-</td>
</tr>
<tr>
<td>Total capital resources after deductions (line 79)</td>
<td>47,200</td>
</tr>
<tr>
<td>Capital resources requirement (Form 1 line 41)</td>
<td>21,500</td>
</tr>
<tr>
<td>Excess of available capital resources (Form 1 line 42)</td>
<td>25,700</td>
</tr>
</tbody>
</table>

2.13. When A completes its PRA return, the regulatory carrying value of the shareholding to be reported on Form 13 will be 25,700. On Form 3, A’s “own” core tier one capital resources will reflect the £50 million book value of its investment in B. The following entries will be made on Form 3 to ensure that the correct contribution of B to group capital resources is reflected.

- 2,500 will be included at line 16 (core tier one in regulated undertakings): this represents the difference between the £50 million book value and B’s total tier one capital before deductions.
- 3,000 will be included at line 36 (deductions in related undertakings) in respect of the amounts deducted from B’s technical provisions for discounting.
- The 2,300 inadmissible assets will be aggregated with A’s own directly held inadmissible assets and included at line 73.

B’s CRR of 21,500 will be reported at Form 1 line 35.

2.14. Reference was made to designated states and territories in paragraph 2.7 in relation to the use of local rules in determining the individual capital resources requirement of a regulated related undertaking. INSINU 6.1.35G confirms that, although this is not explicitly stated in the rules, it is also legitimate to use the local rules of a designated state or territory to determine liabilities and to value assets covering liabilities and the capital requirement.

2.15. INSINU 6.1.41R requires the exclusion from group capital resources of the “restricted assets” of a regulated related undertaking except in so far as those assets are available to meet the individual CRR of that undertaking. Restricted assets arise where a regulated related undertaking has assets which are subject to a legal restriction or other restriction which has the effect that those assets cannot be transferred or otherwise made available to another regulated related undertaking for the purpose of meeting its individual CRR without causing a breach of that legal restriction or requirement. The assets of a long-term insurance fund are deemed by INSINU 6.1.42G to be restricted assets for the purpose of INSINU 6.1.41R. Consequently, if insurer A had a life insurer subsidiary C which had surplus in the long-term business fund of 8,000 at Form 14 line 13 (equating to the fund for future appropriations in C’s accounts) and an individual CRR of 5,000, then for the purpose of A’s group capital resources calculation, although 5,000 of the surplus could be deemed to match C’s CRR, the excess of 3,000 would represent a restricted asset and would need to be excluded from group capital resources.

2.16. The wording of INSINU 6.1.41R and the limited associated guidance together create some uncertainty for insurers as to how it is to be applied.

- It is perhaps unfortunate that INSINU 6.1.41R applies the restriction to “assets”, as the intention (given the example in INSINU 6.1.42G) appears to relate to capital resources rather than assets per se. If the rule relates to assets in the stricter accounting sense of particular items, those might be ‘made available’ (for example by lending) to provide funding elsewhere in the group, without changing the fact that...

149 The entry at line 16 can be positive or negative. A negative figure is likely to arise if there is a goodwill element in the book value of a regulated related undertaking.
150 The logic pointed to by the Regulator when confirming this guidance involves a series of provisions in the Handbook, involving in particular GENPRU 3 Annex 1R (which a non-conglomerate group would normally have no need to refer to) which permit the use, for an entity established in a designated state or territory, of local rules to determine the capital resources as well as the requirement.
the insurer remains subject to the legal obligation to maintain capital resources of the same amount. That seems unlikely to be the intention.

► It is noted that the eligibility of the assets to which the rule relates is restricted to the amount of the individual capital resources requirement. Where the regulated related undertaking is itself a participating insurance undertaking, the assets are treated (in its own adjusted-solo calculation) as available to meet its group capital resources requirement, including that element attributable to its own regulated related undertakings (and investments in such might well themselves form part of the restricted assets). In such a case it seems counter-intuitive to require deduction by reference to the undertaking’s (lower) individual capital resources requirement, whose relevance is limited so far as it is concerned by GENPRU 2.1.13R(2), and an insurer might feel that the reference should by analogy be interpreted to mean the group capital resources requirement (unless of course it really is precluded from investing the funds concerned in its subsidiaries as well as distributing them to its own parent).

► The wording of INSPRU 6.1.42G is problematic in that it states that restricted assets in a particular long term business fund can only be recognised up to the amount of the capital requirement of that fund, rather than the capital requirement of the long term business as a whole. This does not seem soundly based as the capital requirement is a firm rather than a fund concept, and while it can be (and in the context of a realistic reporter has to be) calculated at the fund level, there is no requirement to cover that notional requirement by assets in the fund.

► Finally, it may be noted that some long-term insurers have obtained IG from the Regulator to the effect that surpluses in long-term insurance funds other than with-profits funds are not restricted assets, contradicting the general guidance of INSPRU 6.1.42G (though as noted in chapter 1, such insurers will need to have confirmed with the PRA that they may continue to rely on the IG). If this is the Regulator’s policy, it would perhaps have been preferable to amend the Handbook text rather than give concessions on a case by case basis.

2.17. Although INSPRU does not seem to be explicit as to where, in terms of the INSPRU 6.1.43R table, the ‘exclusion’ of restricted assets should be made, Instruction 33 to Form 3 requires group tier one capital resources to be calculated in accordance with the rules in INSPRU 6.1.41R in relation to restricted assets. It would appear that the exclusion would need to be made in arriving at the line 16 entry for core tier one in related undertakings, rather than dealing with the item as a deduction elsewhere in the table.\(^{151}\)

2.18. Section E of the INSPRU 6.1.43R table deals with “deductions under the requirement deduction method from capital resources”. Despite its seemingly grandiose title, this section deals exclusively with adjustments in respect of ancillary services undertakings, which were discussed in chapter 4 paragraph 2.18 in the context of Form 13. INSPRU 6.1.62R requires the sum of the value of any direct or indirect investment in each of its related undertakings which is an ancillary services undertaking to be deducted. This is analogous with the solo requirement of GENPRU 2.2.255R, save that INSPRU 6.1.63R defines the value of the investment in an ancillary services undertaking as the higher of the book value and the notional CRR of the ancillary services undertaking. Although the distinction is academic in the case of an ancillary insurance services undertaking, as its notional CRR is zero (INSPRU 6.1.64R(1)), other such undertakings will have a notional CRR based on the relevant sectoral rules for a regulated related undertaking whose activities would be closest in scope. It is very difficult to understand why, if this notional CRR is higher than the book value, this should be

\(^{151}\) This interpretation is arrived at largely by elimination. Restricted assets need to be adjusted for on sheet 1 of Form 3 if the group tier one capital resources are to comply with instruction 33. However, adjustment at line 36 as a deduction in related undertakings does not seem appropriate as instruction 42 restricts entries at this line to deductions of the type specified in lines 32 to 35. Also, the rule requires the firm to ‘exclude’ rather than ‘deduct’ the item.
deducted in an adjusted solo solvency calculation, when for solo solvency purposes (and on Form 13), the prescribed deduction appears to be restricted to the book value.\footnote{The method used in these rules, sometimes referred to as the 'requirements deduction method', which is anomalous given that the PRA generally requires the use of the aggregation and deduction method or, by concession, the accounting consolidation method, for insurance groups. Following FICOD1, the method is no longer permitted for financial conglomerates. The rule was amended in 2013 so that it now no longer applies in the case of a calculation for an MFHC conglomerate.}

2.19. Section F of the INSPRU 6.1.43R table and line 77 of Form 3 require deduction of ineligible surplus capital, a concept that (in contrast to that of restricted assets) only applies to regulated related undertakings that are themselves insurance undertakings. INSPRU 6.1.66G explains that the purpose of this requirement is to ensure that group capital resources are not overstated by the inclusion of capital which, although surplus to the requirements of the relevant related regulated undertakings, cannot practically be transferred to support requirements arising elsewhere in the group. This is an inherently reasonable concept, although it is hard to see why it should only be applied to regulated related undertakings that are insurance undertakings.

2.20. INSPRU 6.1.67R defines ineligible surplus capital as the excess of the regulatory surplus value of the regulated related insurance undertaking less restricted assets excluded by virtue of INSPRU 6.1.41R over the transferable capital of that undertaking. If the transferable capital exceeds the adjusted regulatory surplus value, there is no ineligible surplus capital. The transferable capital is defined by INSPRU 6.1.68R as the related undertaking’s tier one capital resources less:

(a) any restricted assets of the related undertaking excluded under INSPRU 6.1.41R

(b) any tier one capital resources of the related undertaking that have been allocated towards meeting the individual CRR of its long-term insurance business

(c) the higher of:

(i) \(50\%\) of the individual CRR of the general insurance business of the related undertaking

(ii) the individual CRR of the related undertaking’s general insurance business less the difference between its tier two capital resources and the amount of its tier two capital resources which have been allocated towards meeting the individual CRR of its long-term insurance business.

2.21. Applying the calculation to the figures for insurer B used in paragraph 2.12 above, the following results:

<table>
<thead>
<tr>
<th>Regulatory surplus value (A)</th>
<th>25,700</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tier one capital resources</td>
<td>49,500</td>
</tr>
<tr>
<td>Restricted assets</td>
<td>-</td>
</tr>
<tr>
<td>Tier one capital resources allocated to long-term CRR</td>
<td>-</td>
</tr>
<tr>
<td>The higher of:</td>
<td></td>
</tr>
<tr>
<td>50% of general insurance business CRR</td>
<td>10,750</td>
</tr>
<tr>
<td>General insurance business CRR less tier two</td>
<td>21,500</td>
</tr>
<tr>
<td>Transferable capital (B)</td>
<td>28,000</td>
</tr>
<tr>
<td>Ineligible surplus capital (as (B) exceeds (A))</td>
<td>Nil</td>
</tr>
</tbody>
</table>

\footnote{The method used in these rules, sometimes referred to as the 'requirements deduction method', which is anomalous given that the PRA generally requires the use of the aggregation and deduction method or, by concession, the accounting consolidation method, for insurance groups. Following FICOD1, the method is no longer permitted for financial conglomerates. The rule was amended in 2013 so that it now no longer applies in the case of a calculation for an MFHC conglomerate.}
2.22. The transferable capital in this instance exceeds the regulatory surplus value because the definition of transferable capital as formulated does not appear to take into account deductions of inadmissible assets (or, for that matter, assets in excess of market risk and counterparty limits).

2.23. It is not easy to understand the logic of this formulation, or how it relates to the intentions expressed in INSPRU 6.1.66G. It makes no reference to restrictions on transferability of surplus capital. In most cases it is likely that there will be no ineligible surplus capital. The PRA provides three examples of the calculation in INSPRU 6.1.69G. These suggest that ineligible surplus capital can only arise where tier two capital is present in the subsidiary, and where it exceeds half of the subsidiary’s CRR.

2.24. In the example given in paragraph 2.12, the simplifying assumption was made that there were no assets in excess of market risk and counterparty limits. However, INSPRU 6.1.70R does require a deduction to be made in respect of assets in excess of market risk and counterparty limits calculated in accordance with INSPRU 6.1.74R, which will be reflected at line 74 of Form 3. This is a complex area, and the drafting of the rules is less than clear. The basic concept is that the insurer will aggregate its own exposures with the surplus assets of its dependants (i.e. regulated related undertakings that are subsidiaries, and other subsidiaries that the insurer has chosen to value on a look through basis) and calculate a deduction computed by reference to any excess of these aggregated values above the limits based on a modified version of the insurer’s own business amount. INSPRU 2.1.22R(5A) substitutes for the firm’s total capital resources after deductions a figure representing group capital resources less the difference between the firm’s group capital resources requirement and the firm’s individual capital resources requirement. Surplus assets equate to the admissible assets representing the excess of the dependant’s capital resources over its CRR. The parent insurer also has the option under INSPRU 6.1.76R to short cut the process, potentially at the cost of additional disallowances, by simply aggregating all of the admissible assets of regulated related undertakings with its own, and applying the limits to that aggregate. This short cut is not available for investments in PRA-regulated insurers, but in that case the determination of surplus assets should be relatively straightforward.

3. The group capital adequacy report (Chapter 9 Part V and Form 95)

3.1. The solvency requirements are applied at the entity level; however, in addition to the “solo” supervision of entities, and the “adjusted solo” approach that has now been introduced for a participating insurance undertaking, there is a need for supervisors to look at an insurance group as a whole. If the parent of an insurer has material borrowings that it has used to inject equity share capital into the insurer, the solvency margin coverage at the parent company level is likely to be significantly worse than at the entity level. An insurer is required, as a consequence of the IGD and FICOD to provide supplementary information of the solvency position at the level of its ultimate insurance parent undertaking and, where different, ultimate EEA insurance parent undertaking. Following rule amendments in 2013, the requirement applies also to EEA and worldwide MFHC conglomerates of which the insurer is a member.

3.2. The report required by Part V of Chapter 9 of IPRU(INS) is referred to as a group capital adequacy report (GCAR).

3.3. The reporting requirements appear in Part V of Chapter 9 of IPRU(INS), and apply to UK insurers that are members of insurance groups or (since 2013) of financial conglomerates headed by mixed financial holding companies. An insurer that has previously reported insurance group capital adequacy at the level of an insurance parent undertaking that is in turn owned by a mixed financial holding company will have to report insurance group capital adequacy in subsequent years also at the level of the MFHC conglomerate. In rule 9.43R, added in 2013, the PRA explained that it would consider waiving requirements in the case of

153 Subject to the proviso that pure reinsurers within the group are subject not to those limits but to the prudent person principles at INSPRU 3.1.61AR.
a conglomerate for which it was the coordinating supervisor, and where it was satisfied that conglomerate reporting under SUP (see section 5 of this chapter) was adequate.

3.4. Information on the group in question is required at both worldwide and EEA levels. The status of the result of the group capital adequacy calculation depends upon whether the group whose solvency is being calculated is headed in the EEA or outside. INSPRU 6.1.15R imposes a ‘hard’ capital adequacy test, requiring a firm to ensure that its capital resources are such that at all times the group capital resources of its ultimate insurance parent undertaking and ultimate mixed financial holding company and, where different, ultimate EEA insurance parent undertaking and ultimate EEA mixed financial holding company, are equal to or exceed that undertaking’s GCRR. This rule is however qualified by INSPRU 6.1.27R, which provides that INSPRU 6.1.15R does not apply in respect of an insurance parent undertaking or mixed financial holding company with its head office in a non-EEA State (with the effect that for non-EEA parented groups the requirement is to report capital only, not to maintain it – whilst reporting an apparent regulatory deficit at the level of such a group would not of itself indicate a rule breach, it would certainly lead to dialogue with the PRA, and potentially to the imposition of requirements intended to protect the interests of EEA policyholders).

3.5. The underlying requirements concerning the calculation of the group capital resources and the GCRR are dealt with by INSPRU 6.1 and correspond to the adjusted solo requirements described in the previous section of this chapter, but with the following points of difference:

► Deductions in respect of market risk and counterparty limits do not need to be made at stage E of the INSPRU 6.1.43R table in arriving at group capital resources.

► Deductions in respect of ineligible surplus capital do not need to be made at stage F of the INSPRU 6.1.43R table in arriving at group capital resources. However, restricted assets of a regulated related undertaking, such as surplus in the long-term business fund in excess of the individual CRR for long-term insurance business of that undertaking, do have to be deducted by virtue of INSPRU 6.1.41R.

► If the competent authority in an EEA State other than the United Kingdom has agreed to be the competent authority for exercising supplementary supervision of the insurance group or MFHC conglomerate of which the firm is a member under Article 4(2) of the IGD, the firm may calculate the group capital resources and GCRR for the ultimate EEA insurance parent undertaking in accordance with the requirements for supplementary supervision of that EEA State (INSPRU 6.1.23R).

► Where the ultimate insurance parent undertaking or mixed financial holding company has its head office in a non-EEA State, the calculation of group capital resources and the GCRR may be made in accordance with accounting practice applicable for the purpose of insurance regulation in that State (INSPRU 6.1.25R). Furthermore, the firm may make an election by written notice to the PRA in accordance with SUP 15.7 to carry out the method in accordance with the accounting consolidation method (INSPRU 6.1.26R). 154

3.6. The limitations on the ‘mix’ of capital in INSPRU 6.1.45R continue to apply to a GCAR as they are incorporated by reference in INSPRU 6.1.36R, which is referred to in rule 9.40(1)(b) of IPRU(INS). Independently from the reporting requirement of IPRU(INS), there is a requirement under INSPRU 6.1.8R for the insurer to calculate group capital resources and the GCRR on a regular basis.

3.7. The submission required by Part V of Chapter 9 has to be provided in principle, under rule 9.40(1), by any insurer with its head office in the United Kingdom to which INSPRU 6.1 applies, but there are two important exceptions.

154 INSPRU 6.1 contains little if any guidance as to how the accounting consolidation method would be applied in practice, and firms adopting this method for determining group capital adequacy should ensure that they can explain the assumptions that they make in this respect.
1. Under rule 9.40(2) there is no need to make a submission to the PRA where the competent authority in an EEA State other than the United Kingdom has agreed to be the competent authority for exercising supplementary supervision of the insurance group or MFHC conglomerate of which the firm is a member, under Article 4(2) of the IGD. The intention in these circumstances would appear to be that the PRA will receive the relevant information directly from the other competent authority. INSPRU 6.1.24G indicates that the PRA will notify the firm where it has reached agreement with the competent authority of another EEA State under Article 4(2): an insurer should check the position with its PRA supervisor unless it can locate such a notification, before it seeks to rely on rule 9.40(2).

2. Where a relevant parent undertaking is itself PRA-authorised and required to submit a global return, the group capital resources and GCRR that would appear in the GCAR will correspond to the figures reported on Form 1 or 2 of the global return, subject to reversal of any adjustments in respect of market risk and counterparty limits and ineligible surplus capital. An additional filing would not serve a useful purpose in these circumstances, and guidance in 9.43 indicates that where the relevant parent undertaking is an insurer with its head office in the United Kingdom, the subsidiary insurer need not provide the rule 9.40 information (although any deficits under rule 9.41 would still need to be reported). It is difficult both to see why this exemption has been provided by way of guidance rather than a rule, and to understand why the guidance only refers to a parent undertaking with its head office in the UK, as an external direct insurer or a pure reinsurer is equally under an obligation to make a global return. The requirement to provide the rule 9.41 information also appears strange as the parent undertaking would have reported information on deficits in regulated related undertakings in supplementary note 1403 or 1504 in its PRA return.

3. In the case of a report for a MFHC conglomerate, rule 9.42E(2) indicates readiness to consider waiver where conglomerate reporting requirements under SUP already provide equivalent information.

3.8. Successive reports must be at dates not more than twelve months apart. The calculation can be prepared as at the end of the financial year of the insurer, or that of the ultimate insurance parent undertaking, ultimate EEA insurance parent undertaking, ultimate mixed financial holding company or ultimate EEA mixed financial holding company for which the report is prepared: the four month filing deadline runs from whichever financial year end is selected. This flexibility is particularly useful for UK subsidiaries of Japanese parents, where there is almost invariably a difference between the Japanese parent’s 31 March accounting date and the UK subsidiary’s 31 December accounting date.

3.9. Rule 9.42(1)(b) requires the calculations to be based on the same date for each member of the group, and for interim calculations to be prepared where members of the group have different financial year ends. There is a concession under rule 9.42(2), whereby interim calculations need not be prepared where this would be “impractical” and the difference between the financial year ends does not exceed three months, provided that the calculations are adjusted to take account of material changes between the group member’s financial year end and the date as at which the submission is prepared. However, it is unclear in what circumstances an “impractical” argument would be accepted (e.g. whether it can be interpreted as applying to immaterial subsidiaries on the grounds of disproportionate effort). The repealed Guidance Note 10.1 had stated that the most recent financial statements should be used where the period difference was three months or less, and that adjustments should be made for material differences where the period difference was more than three months, and this appears a more practicable formulation.

3.10. An insurer will comply with rule 9.40(1) if it submits three figures (group capital resources, the GCRR and the difference between the two) for each relevant parent undertaking and discloses the name, location of the head office and principal activity of the parent undertaking, together with the other prescribed disclosures of Part V. A Form 95 appears in Appendix 9.9 and may be used for the purpose of rule 9.40(1), although this is in no sense
mandatory. Form 95 is a four page Form with five pages of Instructions, which sets out on a step by step basis the derivation of the group capital resources and the GCRR for a group with a modest number of regulated undertakings. The Form is extremely helpful in clarifying the Regulator’s interpretation of the mechanics of its rules. Whether it is appropriate for a particular group needs to be judged on a case by case basis. For a very simple group (e.g. an insurance parent undertaking with a single insurer subsidiary) it may be over-engineered, whereas for a large complex group it may be too simplistic. The Form is based on the aggregation and deduction method, so if an insurer has made a written election to apply the accounting consolidation method for an ultimate insurance parent undertaking or ultimate mixed financial holding company with its head office in a non-EEA State, it would not be appropriate. If a firm chooses not to submit the Form, it should prepare and retain workings to demonstrate how the figures submitted for group capital resources and the GCRR have been determined, so that this information can be made available to the PRA if requested.

3.11. Additional disclosures are required under rule 9.40(1A), in respect of an ultimate EEA insurance parent undertaking or ultimate EEA mixed financial holding company. This provides that where this parent has published annual consolidated accounts in accordance with accounting standards, policies and legislation applicable to it, a reconciliation must be provided between group capital resources as reported under rule 9.40 and the shareholders’ funds, subordinated liabilities and other relevant amounts per the consolidated accounts. Furthermore, where the parent includes in its accounts a capital statement in the form prescribed by FRS27, a reconciliation must be provided between the amounts in the capital statement and group capital resources. The filing date for the rule 9.40(1A) information is extended to 30 days after the publication of the consolidated accounts, where this is later than the filing date for the rule 9.40(1) information.

3.12. Although it is not necessary to provide detailed information on each member of the insurance group or MFHC conglomerate, rule 9.41 requires information on deficits in any related regulated undertaking, which is important for the Regulator to be satisfied as to the adequacy of the distribution of capital within the insurance group or MFHC conglomerate. A deficit arises where the individual CRR for an undertaking exceeds its solo capital resources, and the figure to be disclosed is the full amount of the deficit where the undertaking is a subsidiary (which is consistent with the whole of that deficit being taken into account in the group calculations) or the proportionate share of the deficit in other cases. Deficits in respect of undertakings within a direct ownership chain above or below the insurer always need to be disclosed. Provided the group capital resources exceed the GCRR, disclosure of a deficit in another group undertaking (i.e., one not within the ownership chain) is not required if that deficit is less than 5% of the excess of group capital resources over the GCRR. However, the sum of the undisclosed deficits must not exceed 10% of that excess.

3.13. There is no requirement under the rules for the group capital adequacy report to include any comparative information, though the inclusion of comparative figures and narrative might be considered good practice.

3.14. The auditor’s statement required by rule 9.40(3)(c) is not intended to provide the same assurance as a full audit. A specimen wording has been included in appendix D. There is no requirement for a directors’ statement to be provided, save where one UK insurer submits the report on behalf of another with common reportable parent undertakings, in which case it is necessary for the first insurer to make a statement, signed by two directors, confirming that a copy of the report has been made available to the Board of Directors of the other insurer (rule 9.40(4)).

3.15. Rule 9.40(3)(b) requires the information presented under rule 9.40(1) to be signed by the signatories prescribed by rule 9.33(1). This will in most cases automatically meet the requirement for two directors to sign the confirmation referred to in the foregoing paragraph, when a report is also presented on behalf of another insurer. The submission must comply with SUP 16.3, the main implications of which appear to be that the firm’s reference number should be quoted and the cover sheet contained in SUP 16 Annex 13R should be provided (SUP 16.3.7R).
3.16. It should be noted that the disclosures under rule 9.40(1A) are, whether by chance or design, outside the scope of both the directors’ signatures and the auditor’s statement. Where the information under both rule 9.40(1) and 9.40(1A) is presented in a single document, the auditor’s statement will need to identify clearly which information is within its scope and which is not.

3.17. The return may be lodged either in hard copy (one copy only) or in electronic form. Where the return is lodged in electronic form, the title of the e-mail must be <firm name> group capital adequacy <dd/mm/yyyy>. The address for lodgement of any hard copy and the e-mail address for lodgement are as set out in rule 9.6(2) (see section 5 of chapter 2 above). Although there is no equivalent rule, for the GCAR, of the requirement that applies for the return, to include scanned copies of signed documents when submitting electronically, we understand that it is the PRA’s wish that firms do so.

3.18. The report is a publicly available document. Rule 9.42A requires the insurer to provide to any person within 30 days of a request being received, specific elements of the rule 9.40(1) information in respect of the ultimate EEA insurance parent undertaking (not including the information identified in rule 9.41, so details of individual deficits are therefore not on the public record) and the rule 9.40(1A) reconciliations. Rule 9.42A is not included by reference in rule 9.42E, so the requirement does not apply directly to an insurer in respect of an EEA MFHC conglomerate. However, if the insurer is a member of a UK-regulated EEA financial conglomerate, equivalent information is required under rule 9.42B. The obligation to provide the specified information on request does not apply to a pure reinsurer which was in run-off at 10 December 2007 and has not subsequently been authorised to effect contracts of insurance.

3.19. The rules include provision for the withdrawal and resubmission of an incorrect return.

4. Financial conglomerate reporting

4.1. An insurer that is a member of a financial conglomerate is required by SUP 16.12.32R to submit financial reports to the PRA in accordance with SUP 16.12.33R if it is at the head of a UK-regulated EEA financial conglomerate or if its Part 4A permission applies SUP 16.12.33R to the firm. Rule 9.42C of IPRU(INS) provides a decision tree to assist in determining whether a report is required. There are four types of report required:

(a) calculation of supplementary capital adequacy requirements
(b) identification of significant risk concentration levels
(c) identification of significant intra-group transactions
(d) report on compliance with GENPRU 3.1.35R where it applies (where the financial conglomerate is a UK-regulated EEA financial conglomerate headed by a mixed financial holding company).

4.2. A member of an insurance conglomerate is required to make an annual submission four months after the period end (i.e. the same timing as for the GCAR for an insurance group), except that the report on compliance with GENPRU 3.1.35R, where applicable, is due three months after the period end. Rules 9.42B to 9.42D of IPRU(INS) provide for the public availability of elements of the SUP 16.12.33R submission in a way analogous to an insurance group submission, as described in the previous section. There is, since 2013, no

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155. One, possibly unintended, implication of this is that where information under rule 9.40(1A) is provided separately, for example because the insurer taking advantage of the extended lodgement date due to timing of the consolidated financial statements, no signature is required on that information; however if it is also being provided on behalf of another insurer under rule 9.40(4), the confirmation that the rule 9.40(1A) information has been copied to that other insurer’s Board will still require signature by two directors of the first insurer. These aspects of the rules are confusingly drafted, with rule 9.40(4) presented as a qualification to the general signature requirement for the rule 9.40(1) statement (which it is not) as well as identifying two reports and then using the singular pronoun ‘it’ to express the requirement, leaving doubt as to whether both reports are meant or only one (and if so which).
prescribed format for any of the four required disclosures.\textsuperscript{156}  Note 2 to SUP 16.12.33R states that adequate information must be provided, specifying the calculation method used, and that each financial conglomerate should discuss with the Regulator the form that the reporting should take and the extent to which audit is required.\textsuperscript{157}

4.3. Where an insurer is at the head of the conglomerate, it will already have prepared and submitted an annual PRA return and, unless there is no other insurance undertaking in the group, these will have had to be prepared on an adjusted solo basis using the aggregation and deduction method. It is extremely difficult to see what benefit could conceivably arise from requiring further reporting on a different basis.

4.4. Where an insurer is required to report under SUP 16.3.33R by virtue of a requirement on its Part 4A permission,\textsuperscript{158} it would seem logical to equate the reporting requirements for an insurance-led conglomerate with those of an insurance group. Note 2 to the table in SUP 16.3.33R states that, where relevant to the reporting arrangements agreed with the supervisor, rules 9.40(1), 9.40(1A), 9.40(3) and 9.40(4) apply as though the conglomerate were an insurance group. Indeed, the changes made to Part V of Chapter 9 of IPRU(INS) in 2013, as described in the foregoing section, bring MFHC conglomerates within the scope of that Part, so it is likely here too that an existing report can be used to serve two purposes, with the added potential for reduction of duplication by waiver as mentioned in rule 9.42E(2). The use of Form 95 remains as an option (in past years its use was mandatory for conglomerate reporting only, however if a calculation method other than aggregation and deduction is used to determine group capital adequacy, the Form is unsuitable so the requirement to use it has been dropped).

4.5. Finally, insurers should be aware that in addition to the reporting requirements under SUP 16.12 and under Part V of IPRU(INS), a firm is since 2013 required by SUP 15.9.5R to report ‘regularly’ to the Regulator detailed information on the legal structure and governance and organisational structure of any EEA financial conglomerate of which it is a member (unless that is part of a wider UK regulated EEA financial conglomerate, in which case only the ultimate EEA level is reported). The required detail includes all regulated entities, non-regulated subsidiaries and significant branches. No reporting format is prescribed, and the precise content and frequency of reporting would be a matter for agreement between the firm and the Regulator. A ‘description’, presumably less detailed than the information provided to the regulator, must also be published annually. This requirement may be discharged by reference to other published information.

\textsuperscript{156} Note 6 to the table in SUP 16.12.33R requires this report to be made in the form of a separate item added to the relevant form for sectoral reporting, however this appears to be an oversight as there are no longer specified forms.

\textsuperscript{157} It is to be hoped that the auditor would be consulted as to the practicability of providing any assurance opinion on information to be presented, prior to the conglomerate and the PRA agreeing on its form and content.

\textsuperscript{158} It is not clear that the process of imposing the necessary requirements on Part 4 permission has actually been undertaken by the Regulator in any case, but it is unlikely that any reputable insurer would view it as sensible to seek to avoid making a submission on such a technicality.
Chapter 11 – Other reports to the PRA by insurers

This chapter includes sections dealing with a variety of reports that insurers may need to make to the PRA. The changes to the regulatory architecture, effective at legal cutover, have occasioned some shake-up in the other reporting that has historically been required by the Regulator. Reports that were previously provided to the FSA had at legal cutover to be designated as now to be given to the PRA, to the FCA or to both, and reporting means established.

This chapter deals firstly, in section 1, with additional disclosures in the PRA return relating to material connected party transactions, and with the rule 9.30 statement, also part of the annual PRA return for some insurers. Section 2 addresses the statistical Forms that UK direct insurers with European operations are required to submit, while section 3 deals with the reporting of the ECR for general insurers. Finally, section 4 covers a variety of other reporting requirements, largely arising under the Supervision Manual, which insurers must observe, including the separate annual controllers and close links reports.

Reporting to the FCA is beyond the scope of this booklet, though in some cases it is noted that the rules require reporting to both Regulators, and that some reporting to the PRA is in fact collected by the FCA on its behalf.

This chapter does not cover reporting by insurers of the results of the individual capital assessment referred to in chapter 3, as this is not subject to specific reporting rules and is rather an iterative process of dialogue with the Regulator. Neither does it deal with the Financial Ombudsman Service or the Financial Services Compensation Scheme.

1. Additional disclosures in the return

   Material connected party transactions (rule 9.39)

   1.1. The UK rules have historically required quite extensive disclosure in the return of particular types of transactions with connected parties. Some examples already alluded to in this booklet are:

   ▶ Large counterparty exposures at the year end are disclosed in supplementary notes 1306 and 1312 (which will capture, but are not restricted to, connected party balances).

   ▶ Guarantees, indemnities or other contractual commitments effected other than in the ordinary course of business in respect of the existing or future liabilities of related companies have to be disclosed in supplementary note 1402/1502.

   ▶ Any connection that exists between a general insurer and its major reinsurers and cedants has to be disclosed on the rule 9.25, 9.26 and 9.27 statements.

   ▶ The provision of management services to the insurer by another company (whether connected or not) in respect of long-term insurance business has to be disclosed in supplementary note 4008.

   1.2. Under the IGD, member States are required to ensure that the competent regulatory authorities exercise general supervision over intra-group transactions involving insurers including pure reinsurers, and in particular that there is at least annual reporting of significant transactions to the authorities. If, on the basis of this information, it appears that the solvency of an insurer subject to the EU Directives is, or may be, jeopardised, the authorities must take appropriate measures at the level of that insurer. The general supervision is required to relate to transactions between the insurer and:

   (a) a related undertaking of the insurer;
(b) a participating undertaking in the insurer;
(c) a related undertaking of a participating undertaking in the insurer; and
(d) a natural person who holds a participation in the insurer or any of the undertakings referred to in (a) to (c) above.

The types of transaction over which the Directive requires supervision to be exercised include loans, guarantees and other off-balance-sheet transactions, elements eligible for the solvency margin, investments, reinsurance operations and agreements to share costs.

1.3. The provisions in the Handbook derive predominantly from requirements that already existed under UK regulation (and which already addressed the majority of the IGD requirements), supplemented by a new rule to ensure that all material transactions were disclosed. This rule (9.39) requires disclosure in supplementary notes (2007 and 4009) to the PRA return, and therefore goes beyond the minimum necessary under the Directive by extending the disclosure requirements to all insurers, placing this information on the public record and making it subject to audit.

1.4. The supplementary notes prescribed by rule 9.39 require a brief description of any material connected party transaction agreed to or carried out during the financial year. A connected party transaction represents the transfer of assets or liabilities or the performance of services by, to or for a connected party regardless of whether a price is charged. Such a transaction will be deemed to be material if:

(a) the price actually paid or received for the transfer of assets or liabilities or the performance of services; or
(b) the price which would have been paid or received had that transaction been negotiated at arm’s length between unconnected parties,

exceeds a yardstick figure of:

1. for long-term insurance business, 5% of the insurer’s liabilities arising from long-term insurance business, excluding property-linked benefits and net of reinsurance ceded
2. for general insurance business, the sum of €20,000 and 5% of the insurer’s liabilities arising from general insurance business, net of reinsurance ceded.

1.5. Similar transactions (those of the same type with the same connected party) must be aggregated prior to comparison with the limit. Section 20 of the repealed Guidance Note 9.1 suggested that transactions would be considered to be of the same type if they were combined in the same heading in the profit and loss account (e.g. all reinsurance premiums payable), balance sheet or note to the financial statements, or form part of a connected series of transactions, but went on to indicate, without giving examples, that other groups of transactions may be considered as similar even if they do not meet these criteria.

1.6. The description to be provided must include all of the following items:

(a) the names of the transacting parties;
(b) a description of the relationship between the parties;
(c) a description of the transaction;
(d) the amounts involved;
(e) any other elements of the transaction necessary for an understanding of its effect upon the financial position or performance of the insurer; and
(f) amounts written off in the period in respect of debts due to or from connected parties.

1.7. Transactions with the same connected party may be disclosed on an aggregated basis unless separate disclosure is needed for a proper understanding of the effect upon the financial position or performance of the insurer.

1.8. The repealed Guidance Note 9.1 provided the following list (not intended to be exhaustive) of transactions that are relevant (and clarified that dividends payable are not disclosable unless they are part of a wider transaction):

- loans and similar advances to and from a connected party, including inter-company balances and other such operating arrangements
- investments in the securities or shares of the connected party purchased by the insurer
- investments in the securities or shares of the insurer purchased by the connected party
- guarantees issued to the connected party by the insurer (and other similar off-balance-sheet transactions) or vice-versa
- reinsurance cessions to and acceptances from the connected party
- agreements to share the costs of the connected party, or to share the costs of the connected party with a third party
- payment of commission (including profit commission and commission on reinsurance premiums) and other acquisition costs to the connected party
- transfer of property to or from the connected party, including investments, land, equipment and debts
- transfer of liabilities to or from the connected party, including transfers of business under section 105 of FSMA.

1.9. Some material connected-party transactions may also be disclosable under specific supplementary notes relating to individual Forms. In these circumstances, an appropriate cross-reference will fulfill the requirement provided that all the prescribed details are given.

**Information on controllers (rule 9.30)**

1.10. All UK-incorporated insurers have to include disclosures in the PRA return in relation to the identity of their controllers. Overseas insurers are not subject to this requirement. More extensive reporting, applicable to all insurers and submitted to both Regulators, is discussed in section 5. The two reports overlap extensively.

1.11. A controller is not limited to a person who exercises control over a firm in the sense of being its parent, but is defined by reference to a much lower ownership threshold (managers and directors are not controllers notwithstanding their influence – these are not captured by this requirement but are likely anyway to require individual approval under the approved persons regime). A controller is defined by section 422 of FSMA in relation to an undertaking (B) as a person who:

(a) holds 10% or more of the shares in B or in a parent undertaking of B (P);

(b) holds 10% or more of the voting power in B or P; or
is able to exercise significant influence over the management of B by virtue of his shareholding in B or P.

1.12. The requirements are qualified by anti-avoidance provisions to capture e.g. those exercising control in concert, and concessions to disregard certain trading and similar holdings.

1.13. The rule 9.30 statement is, as part of the PRA return, on the public record. It is not subject to audit. The statement is required to indicate:

(a) the name of each person who, to the knowledge of the insurer, has been a controller at any time during the financial year; and

(b) in the case of each person so named:

(i) the percentage of shares which, to the knowledge of the insurer, he held at the end of the financial year in the insurer or in another company of which the insurer is a subsidiary undertaking; and

(ii) the percentage of the voting power which, to the knowledge of the insure, he was entitled to exercise at the end of the financial year to exercise, or control the exercise of, at any general meeting of the insurer, or another company of which it is a subsidiary undertaking,

in each case either alone, or with any associate or associates.

2. **Statistical information on European operations (Forms 91 to 94)**

2.1. Under European Directives, a system of home country control is applied to an insurer with its head office in an EEA State, and such an insurer does not have to deal directly with the regulatory authorities in another EEA State if it wishes to establish a branch or write business cross-border into that State. The right to conduct business in other EEA States is referred to as a freedom of establishment in the case of a branch, and freedom of services where the business is conducted remotely or by temporary visit. The term ‘passporting’ is commonly used to describe these two activities. As the procedures and reporting requirements differ, an insurer needs to be aware which freedom it proposes to use, since an agency can be sufficient to establish a ‘branch’ and different countries may have different interpretations of the relevant Directives.

2.2. A pure reinsurer can ‘passport’ in under the freedoms of services or establishment, without any requirements for formal consent or regulatory reporting. However in the case of a direct insurer, with which the remainder of this section is concerned, there are procedures to be gone through before business can commenced, but the insurer will apply to its home State regulator, which in turn will communicate with the host State regulator. The procedures described in the next two paragraphs assume that an application is successful; a consent notice can only be refused by the PRA to a UK insurer in the case of a branch if the PRA has reason:

(i) to doubt the adequacy of the firm’s resources

(ii) to doubt its administrative structure

(iii) to question the reputation, qualifications or experience of the directors or managers of the firm or the person proposed as the branch’s authorised agent in relation to the business to be conducted through the proposed branch.

2.3. If a UK direct insurer wishes to establish a branch operation in another EEA State, it needs to submit an application containing the prescribed EU details and UK details to the PRA. Within three months the PRA will forward to the host State regulator a notice containing the EU...
details together with a certificate confirming that the insurer satisfies solvency margin requirements and stating the classes of business for which it has permission in the United Kingdom. The host State regulator has no right of veto, but is allowed a period of two months within which it can specify the conditions which, in the interest of the general good, must be complied with by the insurer in carrying on insurance business through the branch.

2.4. There is a slightly simpler procedure for a UK direct insurer wishing to provide insurance into another EEA State from an establishment in the United Kingdom. Again it will submit an application giving the prescribed details to the PRA. In this case the PRA has a period of one month within which to forward the details to the host State regulator together with a certificate covering the matters referred to in paragraph 2.3. Once this has happened the operation can commence.

2.5. The EEA States in which a UK insurer has passporting rights are stated in its entry on the FS Register. The two freedoms (or establishment and services) are stated separately, and for each freedom for each State the Register entry discloses the classes of business that may be carried on (these will not necessarily include all the classes of business for which the insurer is authorised in the UK; and if an insurer exercises both freedoms with respect to a particular State, the classes of business that it is permitted to carry on under each freedom may differ).

2.6. After the relevant procedure has been completed, there are ongoing obligations both in terms of notifying changes in the requisite particulars and in submitting statistical information. Ongoing obligations in respect of the conduct of the business, for example in respect of documentation content, are outside the scope of this publication. While there is no obligation to provide a regulatory return to the host State authorities, it is necessary to submit information to the PRA in respect of each State. The relevant requirements are set out in Part III of Chapter 9 (rules 9.37 and 9.38) with the prescribed Forms (91 to 94) being set out in Appendix 9.7. As indicated in chapter 1, these requirements are totally separate from the annual return prescribed by the Accounts and Statements Rules.

2.7. The key points to note in respect of these Forms are as follows:

► Forms 91 and 92 relate to general insurance business, with Form 91 dealing with branch business and Form 92 with services business. Forms 93 and 94 relate to long-term insurance business, with Form 93 dealing with branch business and Form 94 with services business. Separate Forms are required for each State; the State should be indicated in the computer heading by insertion of the appropriate country code from paragraph 31 of Appendix 9.2.

► The Forms must be completed for each calendar year, regardless of the financial year of the insurer. If business is not carried on, or services not provided, during the calendar year in respect of a State for which notification has been given, a signed notification of this fact needs to be submitted to the PRA instead of the Forms.

► The Forms must be lodged with the PRA within four months of the end of each calendar year, either in hard copy or electronically, in a similar manner to the return, but using the e-mail title <firm name> EEA forms <dd/mm/yyyy> when submitted electronically. The Forms (in practice, a cover sheet to the Forms) must be signed by a director, a chief executive or the secretary of the insurer. If the Forms are submitted electronically, a scanned pdf copy of the signed page is required. The Forms are not subject to audit.

► In completing the Forms, figures should be determined using the same accounting principles as are used for compiling the return, and the normal conventions for preparing Forms under the Accounts and Statements Rules should also be followed.

► The implications of the late submission of these Forms are similar to those that apply to the annual returns (see chapter 2 paragraph 5.2). Unlike the case with the return,
3. General insurance enhanced capital requirement (Form ECR1)

3.1. The enhanced capital requirement for general insurers is described at paragraph 3.17 of chapter 3 above. The ECR, which INSPRU 1.1.72BR requires a general insurer to calculate unless it is a non-directive insurer or a Swiss general insurer, was designed as a more risk-sensitive measure of capital needs, to supplement the basic formulae prescribed by European Directives and reflected on Forms 11 and 12. However, unlike the ECR for long-term insurers, the ECR for general insurers is not a 'hard' capital requirement (though that had been the Regulator's original intention). Its current role is to provide input to the process of assessment of the insurer’s ICA, and in many cases the ICG given by the PRA will be articulated as a multiple of the ECR. Again unlike the ECR for long-term insurers, the ECR is not included in the annual PRA return. The separate Form which is used to report the ECR has a number of inconsistencies and anomalies as noted below, which may cause an insurer a need to consult with its PRA supervisor as to the appropriate approach in some circumstances.

3.2. Any insurer carrying on general insurance business (other than a non-directive insurer or a Swiss general insurer) is required by rule 9.44 to report its ECR as at the end of the financial year on Form ECR1, which appears in Appendix 9.10. The timing of the submission of Form ECR1 is in effect aligned with the annual return, although it does not form part of the annual PRA return and is therefore not on the public record (the different basis of calculation, together with the operation of de minimis limits in the presentation of the information in the annual return, means that it cannot readily be estimated from the information in the annual return either). Rule 9.44 requires submission of either a printed copy within two months and 15 days of the end of the financial year, or an electronic copy within three months. The signature requirements and lodgement addresses are the same as for the annual return, and when lodgement is electronic the signed page must be included as a pdf. The prescribed title of the e-mail is ‘<firm name> Form ECR1 <dd/mm/yyyy>’.

3.3. The ECR submission is required by IPRU(INS) to be carried out at the legal entity level, and the INSPRU rules are articulated by reference to “the firm”: there is no requirement in the rules for a UK branch ECR submission to be made. CP 05/9 indicated that groups which currently had a concession to submit a consolidated general insurance business return could apply for a waiver to submit the ECR calculation on a similar basis. However, if such a waiver was granted, the Regulator intended to require the submission of a form stating the ECR, minimum capital requirement, financial resources, net written premiums and claims provisions for each individual insurer included in the consolidation, so that the Regulator could see how capital resources and risks were distributed among the firms to which the waiver applied.

3.4. Form ECR1 has the following sheets, corresponding to the structure of the ECR as comprised of capital charges based on assets, on net premiums and on technical provisions:

1. Summary
2. Asset-related capital charge
3. Insurance-related capital charge – accident year business
4. Insurance-related capital charge – underwriting year business

3.5. The summary sheet presents the build up of the ECR from the data on the underlying sheets less the equalisation provision. It also states capital resources and MCR per the annual return and ICG where this has been given, and calculates various ratios. There is an anomaly on the Form in the case of an insurer performing an adjusted solo calculation in its
PRA return, as the capital resources requirement of regulated related undertakings is not taken into account anywhere on the Form but the capital resources stated are those from line 13 of Form 1, i.e. the group capital resources in that case.

3.6. The asset-related capital charge sheet is set up to correspond to lines or groups of lines on the category 1 Form 13. The entries in column 1 for each line will correspond to the values recorded on Form 13, as INSPRU 2.2.11R(3) states that no account is to be taken of assets that are inadmissible or which exceed the limits on exposure to an asset or counterparty set out in INSPRU 2.1.22R. The total line is required to correspond to Form 13 line 89 + 87 – 44. These adjustments to the total arise because derivatives are dealt with separately in column 2. This column sets out derivative adjustments, the purpose of which is to ensure that where a firm has entered into a derivative, the value of the derivative and the value of the asset associated with the derivative are treated as a single asset which most closely reflects the economic risks to the firm of the combined risks and obligations associated with the derivative and the related asset. Thus if a firm had an “in the money” option to purchase a particular equity share, the correct approach would be to combine the cash cost of acquiring the shares with the value of the derivative and to record this in column 2 at the line relating to shares (with a negative entry at the cash line) and to apply a 16% factor.

3.7. The asset-related capital charge factors prescribed in INSPRU 2.2.16R are applied to the sum of columns 1 and 2 in order to arrive at the asset-related capital requirement. The prescribed factors range from 0% for cash and deposits to 16% for shares and other variable yield participations, units in unit trusts and participation in investment pools. INSPRU allows a 0% factor to be applied to a money market fund, which is defined by INSPRU 2.2.14R as a participation in a collective investment scheme which invests exclusively in cash or in short term instruments with characteristics similar to cash or both and which satisfies a number of additional conditions. However, no other concession is currently available for collective investments, and the 16% factor therefore applies (for example) to collective investment schemes which invest exclusively in land or in fixed interest securities, which if held directly have appreciably lower factors. This appears particularly anomalous as a life company in completing Form 48 will make a full allocation of collective investment schemes to the underlying asset types in the economic exposure column.

3.8. Sheets 3 and 4 deal with the calculation of the insurance-related capital component on respectively an accident year and an underwriting year basis. INSPRU 1.1.79R provides a table setting out the factors to be applied to net written premiums including late-booked premiums, and to technical provisions by category of business. The categories are the combined categories as used to report revenue information in the annual PRA return, though no calculation is performed on the ‘super-combined’ categories 001, 002 and 003. Form ECR1 links these categories to the cells on the Forms from the annual return in which the information would appear, though because of the de minimis limits those Forms will not necessarily have been prepared for all of the categories. There are no de minimis limits for the purposes of the ECR however, and the factor must be computed on ECR1 regardless.

3.9. Technical provisions are defined for this purpose by INSPRU 1.1.78R as comprising:

1. provision for outstanding claims
2. provision for incurred but not reported (IBNR) claims
3. provision for incurred but not enough reported (IBNER) claims

159 Here too though, there seems an anomaly as, if line 87 has been used to identify assets which are shown elsewhere on Form 13 after individual restriction but remain collectively in excess of aggregate counterparty or market risk limits set out in INSPRU 2.1.22R(3)(d), (e), (f), (i) or (j), then calculating a capital charge on the element of those assets that is deducted at line 87 rather than on the asset line concerned contradicts the requirement in INSPRU 2.2.11R(3).

160 For example, the scheme does not allow the assets held to exceed a weighted average maturity of 60 days.
4. unearned premium provisions\(^{161}\) less deferred acquisition costs

5. unexpired risk provisions,

in each case net of reinsurance receivables. Interesting points of this definition include:

► The requirement to net deferred acquisition costs against unearned premiums.

► The specific reference to IBNER, a term which does not seem to feature anywhere else in INSPRU or IPRU(INS).

► The absence of a specific reference to claims management costs. However, as the prescribed sources on ECR1 include Form 22 lines 14 and 18 and Form 24 line 15 which deal with claims management costs, it must be assumed that it is the intention for these to be included (whereas in the gross undiscounted provisions materiality test considered in chapter 6 where the rules are equally silent, it is intended that these should be excluded).

► The reference to reinsurance receivables, which in accounting terms generally relates to amounts due from reinsurers as opposed to the reinsurers’ share of technical provisions that will become a receivable when and if the liability represented by the technical provision crystallises. It is however clearly the reinsurers’ share of the technical provisions that is meant.

3.10. The factors for the insurance-related capital requirement are prescribed in INSPRU 1.1.79R and range for net written premiums from 5% to 61% and for net technical provisions from 9% to 17%. These factors were originally calibrated against the accounting classes and business categories used prior to 2005 for reporting general insurance business, and a number of respondents urged the Regulator at the time to consider recalibrating the ECR to take account of the change that occurred then, however the Regulator expressed no enthusiasm then and the idea is now completely off the agenda in view of the forthcoming implementation of Solvency II.

4. Other information

4.1. There are other requirements, principally set out in the Supervision Manual, requiring information to be made available by an insurer to the PRA outside the annual return and the other filings discussed in the earlier part of this chapter. The following will be considered in this section.

► annual and ad hoc controller reporting

► annual and ad hoc close links reporting;

► quarterly reporting;

4.2. In addition there are other ad hoc filings and applications – for example to obtain approval of a person to perform controlled functions, or to notify membership of a financial conglomerate – of which an insurer must be aware. It is vital that an insurer’s senior management recognises the need to keep track of all the relevant Handbook requirements and that responsibilities in this respect are appropriately apportioned. It is also essential to remain aware of the more general requirement to notify the appropriate Regulator when necessary under Principle 11 (SUP 15.3 expands upon the Regulators’ requirements and expectations in this regard). Finally, a number of reporting requirements relate to the FCA, predominantly those relating to insurance mediation, outside the scope of this booklet and mentioned only briefly here.

\(^{161}\) Here and in (5), the INSPRU text refers to reserves rather than provisions, which is disappointing.
Chapter 11 – Other reports to the PRA by insurers

Controllers reporting

4.3. Section 2 referred to the rule 9.30 statement which a UK-incorporated insurer is required to include in its PRA return, detailing the persons who have been controllers at any time during the year. This is only a part of the requirements in respect of reporting on controllers.

4.4. Firstly, changes in control require to be reported. Part 12 of FSMA requires a person to notify the appropriate Regulator in writing if he proposes to take a step which would result in his acquiring control or increasing or reducing his control over a UK domestic firm (somewhat less onerous provisions apply to overseas firms). If the firm is an insurer, the PRA is the appropriate Regulator. Benchmark steps for notification of increases are from below 10% to 10% or more but less than 20%; from below 20% to 20% or more but less than 30%; from below 30% to 30% or more but less than 50%; and from below 50% to 50% or more. The notification should be made by e-mail, to PRA-changeincontrol@bankofengland.co.uk. Forms for the notification of the acquisition or increases of control are prescribed by the Supervision Manual (there is no prescribed form for notification of a decrease). When a notice of control is submitted to the PRA (which must consult with the FCA), it has 60 working days within which to approve or reject the person concerned having the control to which the notice relates.

4.5. Firms also need to provide an annual controllers report, which inter alia enables the PRA to check that all necessary notifications have been made. The report, which is required by SUP 16.4.5R, should correspond to the previous year’s report as adjusted for changes of control notified to and approved by the PRA during the year. This, unlike the rule 9.30 statement, is required of all insurers.

4.6. The report is unaudited and not on the public record, and must be submitted within four months of the accounting reference date. As SUP 16.5.4R is in both Regulators’ Handbooks, it must be submitted to both regulators, though the Regulators have taken the pragmatic approach that the FCA will receive it on behalf of both. The FCA currently instructs firms to submit the report via e-mail to regulatory.reports@fca.org.uk, or by post, fax or hand delivery. It is intended to make electronic submission mandatory through the FCA’s GABRIEL system.

4.7. The report must contain a list of all the controllers as at the firm’s accounting reference date of which it is aware and for each such controller state:

(a) its name;

(b) the percentage of voting power in the firm, or in the firm’s parent undertaking, which it is entitled to exercise or control the exercise of, whether alone or with any associate;

(c) the percentage of shares in the firm, or in the firm’s parent undertaking, which it holds, whether alone or with any associate; and

(d) one of the following, if it applies:

(i). if the controller is a body corporate, its country of incorporation, address and registered number, or

(ii). if the controller is an individual, his date and place of birth.

162 The duty to notify changes in control applies separately to the firm and to the controller/proposed controller, but these duties can often be discharged through a joint notification.

163 The PRA has the ability to interrupt the assessment period once, for no more than 20 days (or under some circumstances 30), to seek additional information.

164 With effect from the 2013 year-end, a firm is no longer able to submit, in lieu of the report, a simple statement of the fact that it is not aware that is has any controllers, or of any change in the identity of its controllers since the submission of its previous report, or of any changes in the percentage of shares or voting power in the firm held by any controllers since the submission of the previous report.
Chapter 11 – Other reports to the PRA by insurers

4.8. Although the information required by the rule 9.30 statement and the annual controllers report is very similar, there are some differences. Rule 9.30 names controllers during the year that ceased to be controllers at the year end (unlike SUP 16.4 which relates exclusively to the year end statement) but does not disclose the country of incorporation, address and registered number of body corporate controllers or the date and place of birth of individual controllers. Insurers concerned about the apparent duplication of information will be pleased to note that SUP 16.4.12R indicates that a report need not be submitted under SUP 16.4 to the extent that the information has already been provided to the PRA under rule 9.30. Given the differences in the requirements, there may be some merit in an insurer voluntarily adding the additional SUP 16.4 particulars to the rule 9.30 statement if it wishes to avoid a SUP 16.4 submission altogether, unless of course it wishes to keep the additional particulars off the public record.

Close links reporting

4.9. The concept of close links is derived from the post-BCCI Directive and the assessment of one of the threshold conditions in Schedule 6 to FSMA (paragraph 4F on effective supervision by the PRA) requires consideration, where close links exist between a firm (C) and another person (CL), of:

► The nature of the relationship between C and CL;
► Whether those links or that relationship are likely to prevent the PRA’s effective supervision of C.
► If CL is subject to the laws, regulations or administrative provisions of a territory which is not an EEA State whether those provisions, or any deficiency in their enforcement, would prevent the PRA’s effective supervision of C.

4.10. For the above purposes, C is deemed to have close links with CL if:

► CL is a parent undertaking of C
► CL is a subsidiary undertaking of C
► CL is a parent undertaking of a subsidiary undertaking of C
► CL is a subsidiary undertaking of a parent undertaking of C
► CL owns or controls 20% or more of the voting rights or capital of C
► C owns or controls 20% or more of the voting rights or capital of CL.

4.11. Under SUP 11.9, an insurer is required to notify both Regulators as soon as reasonably practicable and no later than one month after it has become aware that it has become or ceased to be closely linked with any person. The notification must state the name of the person, the nature of the close links and the requisite particulars of the person depending on whether the person is a body corporate or an individual. There is provision for firms to elect to report changes in close links monthly rather than ad hoc, in which case the deadline is fifteen business days after the end of each month. Election must be in writing and the Regulators consider that monthly reporting will normally be appropriate only for members of large groups.

4.12. In practice, the notification is made once only, by e-mail to the FCA (regulatory.reports@fca.org.uk), using the prescribed Form. In order to avoid duplication,
one member of a group may submit the report on behalf of other firms in the group, provided it identifies them. The FCA collects the reports and notifies the PRA.\textsuperscript{167}

4.13. In addition to a requirement to report changes in close links, a firm that has not elected to report monthly is also required to submit an annual close links report, also to both Regulators (again, it is in practice sent only to the FCA, currently by e-mail but moving to use the GABRIEL system). The report required by SUP 16.5.4R is similar in many respects to the annual controllers report considered earlier in this section and at one time could be combined with it provided it contained the information required on both controllers and close links. However from the 2013 year end this facility was abolished and a separate report is required. Within four months of the accounting reference date, a firm must submit either a statement that it is not aware that it has any close links or of any material changes to the details since the submission of the previous report or a list of all closely-linked persons as at the accounting reference date of which it is aware, and for each such person state:

- its name
- the nature of the close links
- if the close link is with a body corporate, its country of incorporation, address and registered number
- if the close link is with an individual, his date and place of birth.

Unless a firm has no close links, it must submit a group organisation chart as part of the report. A firm that reports monthly must submit the organisation chart quarterly unless there have been no changes since the previous organisation chart was submitted.

4.14. As with the ad hoc or monthly notifications under SUP 11.9, the submission may be made by one authorised firm on behalf of other group members, provided those other group members are identified in the submission.

\textit{Quarterly reporting}

4.15. Insurers meeting certain conditions are required to submit financial information to the PRA on a quarterly basis. The precise number affected is not a publicly available statistic. Quarterly reporting is normally an obligation under Appendix 2 to the Supervision Manual in respect of any insurer that has submitted a “scheme of operations” to the PRA. Various circumstances can trigger a requirement for a scheme of operations including:

- capital resources falling below the guarantee fund (SUP Appendix 2.4.1R) – requires a scheme of operations within 14 days
- capital resources falling below the required margin of solvency (SUP Appendix 2.5.1R) – requires a scheme of operations within 28 days
- a decision to cease to effect new contracts of insurance (SUP Appendix 2.8.1R) – requires a scheme of operations within 28 days
- application for variation of Part 4A permission (SUP 6.3)
- application for cancellation of Part 4A permission (SUP 6.4)
- application for authorisation (the regulatory business plan required to be submitted is deemed to be a scheme of operations)

\textsuperscript{167} Although the rules suggest that the notification form is different for the two regulators, the hyperlink on the PRA website actually links to a template on the FCA website which bears the logos of both Regulators.
4.16. Certain of these triggers derive from European Directives, and use terminology that is no longer used in GENPRU and INSPRU, or that has different meanings. SUP Appendix 2.2 provides interpretation. Taken literally, SUP Appendix 2.2.1R(1)(b) indicates that capital resources for participating insurance undertakings are before deductions, however such an interpretation would seem contrary to the intention of the rules and it would be prudent to assume that the term should be interpreted as after deductions. In particular, capital resources for a participating insurance undertaking is defined as the sum of its group tier one capital resources and group tier two capital resources; the definition implies that these are prior to deductions, however it appears reasonable to assume that capital resources after deductions are meant. It should also be noted that the ‘required margin of solvency’ referred to in the triggers does not include any resilience capital requirement or WPICC, and represents the GICR or LTICR even if that figure is below the base capital requirement. In the case of a participating insurance undertaking, it will be the group capital resources requirement after deduction of any resilience capital requirements or WPICCs.

4.17. In the past, the triggers have also included significant changes to a firm’s operations arising from a change of control could also trigger a requirement for a scheme of operations; although this is no longer the case, requiring a scheme of operations remains within the general toolbox of supervisory actions of the Regulator.

4.18. Whatever the trigger may be, for the period covered by the scheme (or any revised scheme of operations) the insurer must, under SUP Appendix 2.13.1R:

- notify the PRA at least 28 days before entering into or carrying out any material transaction with or in respect of an associate, unless that transaction is in accordance with a scheme of operations which has been submitted to the PRA;
- submit a quarterly financial return to the PRA;
- notify the FSA promptly of any matter which has either happened or is likely to happen and which represents a significant departure from the scheme of operations.

4.19. The quarterly return is required to include a summary profit and loss account, a summary balance sheet and a statement of capital resources, all prepared in accordance with the requirements of SUP Appendix 2.12 for the scheme of operations, and which must identify and explain differences between the actual results and the forecasts submitted in the scheme of operations. The Appendix 2.12 scheme of operations requirements represent items to be included rather than a prescribed format, and it therefore appears that the information can be free form. The required items are as follows:

**Summary profit and loss account**

1. Premiums and claims (gross and net of reinsurance) analysed by accounting class \(^{168}\) of insurance business
2. Investment return
3. Expenses
4. Other charges and income
5. Taxation
6. Dividends paid and accrued

\(^{168}\) SUP Appendix 2 continues to refer to accounting classes of business, although these were replaced in IPRU(INS) by reporting categories in 2005. Somewhat confusingly, whereas “accounting class” was formerly a defined term, the drafting of SUP Appendix 2 recognises that this is no longer the case but instead refers to the defined term “class”, which means (for general insurers) the 18 authorisation classes, but prefaced by the undefined term “accounting”, a combination without clear meaning.
Summary balance sheet

1. Investments analysed by type
2. Assets held to cover linked liabilities
3. Other assets and liabilities separately identifying cash at bank and in hand
4. Capital and reserves analysed into called up share capital or equivalent funds, share premium account, revaluation reserve, other reserves and profit and loss account
5. Subordinated liabilities
6. The fund for future appropriations
7. Technical provisions gross and net of reinsurance analysed by accounting class of insurance business and separately identifying the provision for linked liabilities, unearned premiums, unexpired risks and equalisation
8. Other liabilities and credits

Statement of capital resources

The statement of capital resources must include the capital resources and the required margin of solvency at the end of the period.\(^{169}\)

4.20. SUP Appendix 2 curiously does not specify a deadline for submission of a quarterly return, though SUP 16.3.6R – 13R prescribe a number of other formalities relating to the submission

4.21. Where the insurer submitting the quarterly return is a composite, SUP Appendix 2.12.6G states that information should be submitted separately for general and long-term insurance business. In addition, if the insurer is a non-EEA insurer operating in the UK through a branch, SUP Appendix 2.12.5G indicates that information should be submitted separately for the UK branch and the company as a whole.

Other reporting to the FCA

4.22. A number of other returns are made to the FCA only and for reasons of space are beyond the scope of this booklet. These include the following:

- A persistency report is required by SUP 16.8.3R of every insurer with permission to effect or carry out life policies. The report is submitted annually by e-mail.\(^{170}\) A similar report is required of firms operating stakeholder pensions.

- A Retail Mediation Activities Return (RMAR) is required by SUP 16.12, for insurers holding insurance mediation permissions; this is the mechanism for a general insurance intermediary to report both prudential and conduct of business information but for an insurer is restricted to the conduct of business information. SUP 16.12 is potentially very confusing and an insurer approaching it may find it helpful to validate its understanding with its FCA supervisor. A small number of insurers with home finance providing activity or administering home finance transactions are required to submit a Mortgage Lenders and Administrators Return (“MLAR”) in addition to (or instead of) the RMAR. These returns are twice-yearly, and submitted using the GABRIEL system.

\(^{169}\) The requirement referenced at SUP Appendix 2.12.9R is actually for a forecast of capital resources and required margin of solvency, but it appears the intention of SUP Appendix 2.13.1R(2) that the quarterly reports disclose actual figures at the reference date.

\(^{170}\) A life policy is defined for this purpose as a long-term insurance contract other than a reinsurance contract or a pure protection contract.
A complaints report is required twice a year under DISP 1.10, concerning complaints received from eligible complainants. A separate report is required for complaints in respect of retail investment advice. Both reports are due 30 days after the period end, and are submitted electronically.

4.23. The FCA also collects information on behalf of the Financial Ombudsman Service.
Appendix A  Form 13 – Valuation of assets

Chapter 4 contains a general discussion of the valuation of assets included on Form 13. This appendix examines each line on the Form, identifies the equivalent format heading in Schedule 3 and states the valuation rule applying, the basis on which the asset is admissible under GENPRU 2 Annex 7R, and any restriction expressed in terms of the business amount. The admissibility and restriction references are not applicable to pure reinsurers, to which the prudent person investment principles of INSPRU 3.1.61AR apply (see chapter 4 paragraph 3.6).

In describing the valuation rules, the following terms have been used:

“GAAP” means that under GENPRU 1.3.4R, the asset is to be valued in accordance with:

► the insurance accounts rules
► Financial Reporting Standards and Statements of Standard Accounting Practice issued or adopted by the Accounting Standards Board
► Statements of Recommended Practice issued by industry or sectoral bodies recognised for this purpose by the Accounting Standards Board
► International Accounting Standards (as adopted by the European Commission).

“Investments” mean that the asset falls within GENPRU 1.3.41R, and is to be marked to market where possible under GENPRU 1.3.14R or marked to model under GENPRU 1.3.17R and the following rules, with in either case reference to the additional requirements of GENPRU 1.3.26R – 35G as to model governance and consideration of valuation adjustments (having regard to the PRA’s focus on valuation uncertainty).

As explained in chapter 4, an insurer still needs to consider the value to be placed in the first instance on an investment that is excluded from Form 13 by virtue of not being admissible, or whose value on that Form is restricted by reference to the market risk and counterparty exposure limits. The requirements of GENPRU 1.3 referred to above should be applied to such investments, as appropriate.

With the exception of the restrictions relating to lines 11, 43 (in most cases) and 82, the business amount limits relate to counterparty exposures rather than individual assets. Where there is an exposure to a counterparty relating to more than one type of asset, it will therefore be necessary to aggregate the exposures to determine whether the limit has been exceeded. If a write down is necessary in these circumstances, it would be logical to pro-rate this over the lines in question.

11  Land and buildings

Schedule 3: Asset item CI

Valuation rule: GAAP (GENPRU 1.3.4R). Admissibility: (1)(A)(e).

Restriction: The maximum admissible value of a 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 is 10% of the business amount (INSPRU 2.1.22R(3)(h)).
21 UK insurance dependants - shares
22 UK insurance dependants - debts and loans
23 Other insurance dependants - shares
24 Other insurance dependants - debts and loans
25 Non-insurance dependants - shares
26 Non-insurance dependants - debts and loans

Schedule 3: Lines 21, 23 and 25 relate to asset item CII 1 and lines 22, 24 and 26 to asset item CII 2; however the Schedule 3 headings are wider in scope since these include group companies falling outside the “dependant” definition, which will be dealt with at lines 27 and 28. A “dependant” represents a subsidiary undertaking shares in which are valued on a “look through” basis (either mandatorily under GENPRU 1.3.43R(1), or by election under GENPRU 1.3.43R(3)).

Valuation rule: For shares (lines 21, 23 and 25), there is a look through under GENPRU 1.3.47R to the regulatory surplus value of the dependant (the insurer’s proportionate share of the dependant’s capital resources after deductions less its individual CRR) less the book value of the investments by the firm and its related undertakings in the tier two capital resources of the dependant, and less (in the case of a dependant that is an insurance undertaking included at line 21 or 23) its ineligible surplus capital and restricted assets. Debt securities and loans are valued at book value (GENPRU 1.3.44G).

Admissibility: (1)(A) (a), (b) or (c).

Restriction: None directly, since a subsidiary undertaking valued under GENPRU 1.3.43R is outside the Handbook glossary definition of “counterparty”, although the dependant’s exposure to an asset or to a counterparty will be aggregated with the insurer’s for the purpose of comparing with the business amount.

27 Other group undertakings - shares
28 Other group undertakings - debts and loans

Schedule 3: Asset items CII 1 and 2 respectively, although the Schedule 3 heading also includes shares in and loans to dependants (lines 21 to 26 above).

Valuation rule: Accounting book value for ancillary services undertakings (GENPRU 1.3.44G, though pursuant to GENPRU 2.2.255R and Instruction 4(c) to Form 13 both Forms 3 and 13 show the investment at nil). Otherwise value as investments (GENPRU 1.3.41R). It should be emphasised that the provisions of GENPRU 1.3.43R and 1.3.44G do not apply to loans to an insurer’s parent undertaking or fellow subsidiaries of the insurer, as the Handbook glossary definition of “related undertaking” does not include these entities and these therefore need to be valued as investments in accordance with GENPRU 1.3.41R.

Admissibility: (1)(A) (a), (b) or (c).

Restriction: Normal limits applicable to that type of counterparty.

29 Participating interests - shares
30 Participating interests - debts and loans

Schedule 3: Asset item CII 3 and 4 respectively. A participating interest arises where shares are held on a long-term basis for the purpose of securing a contribution to the activities of the other undertaking by the exercise of control or influence arising from or related to that interest. A holding of 20% or more of the shares is presumed to be a participating interest unless the contrary is shown.

Valuation rule: As for lines 21 to 26 in the case of participations in regulated related undertakings and debt securities issued by, and loans to, entities in which the participations...
are held. Otherwise value as investments (GENPRU 1.3.41R). **Admissibility:** (1)(A) (a), (b) or (c).

**Restriction:** Normal limits applicable to that type of counterparty.

41 **Equity shares**

42 **Other shares and other variable yield participations**

**Schedule 3:** Asset item CIII 1 (which also relates to line 43).

**Valuation rule:** Investments (GENPRU 1.3.41R). **Admissibility:** (1)(A)(c).

**Restriction:** Counterparty restriction of 5%/10% of the business amount if the issuer is an approved counterparty (INSRU 2.1.22R(3)(b)(i)). Otherwise, counterparty restriction of 5% of the business amount (INSRU 2.1.22R(c)(iii)), but reduced to 1% of the business amount for shares and securities that are not dealt in on a regulated market, unless the counterparty is a regulated institution (INSRU 2.1.22R(c)(ii)).

43 **Holdings in collective investment schemes**

**Schedule 3:** Asset item CIII 1 (which also relates to lines 41 and 42).

**Valuation rule:** Investments (GENPRU 1.3.41R).

**Admissibility:** (1)(A)(d). Holdings are admissible if they are in a UCITS scheme, a non-UCITS retail scheme, a recognised scheme or any other scheme where the insurer’s 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 insurer to enable it to monitor the investment risk being taken by the scheme.

**Restriction:** None in the case of holdings in a UCITS scheme (INSRU 2.1.33R(9)). Otherwise there is normally an asset exposure limit of 5% of the business amount in respect of a beneficial interest in a non-UCITS retail scheme or recognised scheme (INSRU 3.1.22R(3)(i)) or 1% of the business amount in respect of the business amount in any other scheme (INSRU 3.1.22R(3)(j)). However, if the issuer of the units in a non-UCITS scheme and the units are so connected that if the issuer were to experience financial problems this would be likely to affect the value of the units, the units must be treated as a counterparty exposure to the issuer (INSRU 3.2.29R). The relevant counterparty exposure limit in this case is 5%/10% of the business amount where the issuer is an approved counterparty (INSRU 2.1.22R(3)(b)(i)), or 1% of the business amount otherwise (INSRU 2.1.22R(3)(c)(ii)).

44 **Rights under derivative contracts**

**Schedule 3:** Asset item CIII 7.

**Valuation rule:** Investments (GENPRU 1.3.41R). Derivatives are discussed in detail in section 4 of chapter 4.

**Admissibility:** (1)(A)(f). A derivative contract only represents an admissible asset if it is “approved”, which necessitates that it satisfies the three conditions of INSPRU 3.2.5R:

1. It is held for the purpose of efficient portfolio management or reduction in investment risk.
2. It is covered.
3. It is effected or issued.
   * on or under the rules of a regulated market
off market with an approved counterparty and, except for a forward transaction, on approved terms and is capable of valuation.

Restriction: The exposure towards the party issuing a derivative is included in the relevant counterparty exposure calculation. Furthermore, assets that an insurer is deemed to have acquired or disposed of under derivative contracts impact on its exposure to the counterparty to which the underlying asset relate.

45 Fixed interest securities - approved
46 Fixed interest securities - other
47 Variable interest securities - approved
48 Variable interest securities - other

Schedule 3: Asset item CIII 2. This heading includes securities bearing interest rates that vary in accordance with specific factors, for example the interest rate on the inter-bank market.

Valuation rule: Investments (GENPRU 1.3.41R).

Admissibility: (1)(A)(a).

Restriction: None for approved securities (INSPRU 2.1.33R(8)). Counterparty restriction of 5%/10% of the business amount if the issuer is an approved counterparty (INSPRU 2.1.22R(3)(b)(iii)). Otherwise, counterparty restriction of 5% of the business amount (INSPRU 2.1.22R(c)(iii)), but reduced to 1% of the business amount for debt securities and other money market instruments and capital market instruments that are not dealt in on a regulated market, unless the counterparty is a regulated institution (INSPRU 2.1.22R(3)(c)(iii)).

49 Participation in investment pools

Schedule 3: Asset item CIII 3. This heading comprises shares held by the insurer in joint investments constituted by several undertakings or pension funds, the management of which has been entrusted to one of those undertakings or to one of those pension funds.

Valuation rule: This will vary according to the underlying investments, but will usually be investments (GENPRU 1.3.41R). Admissibility: This depends upon the admissibility of the underlying investments.

Restriction: Based on the underlying counterparty.

50 Loans secured by mortgage

Schedule 3: Asset item CIII 4.

Valuation rule: Investments (GENPRU 1.3.41R).

Admissibility: (1)(A)(b).

Restriction: For individuals 1% of the business amount if the loan is fully secured on that individual’s main residence, otherwise ¼% (INSPRU 2.1.22R(3)(a)). For a body corporate, 5% of the business amount (INSPRU 2.1.22R(3)(c)(iii)).

INSPRU 2.1.22R(7) might be read to bring debt securities, whether listed or not, that are unsecured also within the limits for unsecured debt at INSPRU 2.1.22R(3)(c)(i); however this was not the sense of the more explicit articulation of the rules and guidance prior to PRU, and would result in the anomaly of such debt securities being more restricted than shares, to which they rank senior. This seems unlikely to be the intention of the rules.
51 Loans to public or local authorities and nationalised industries or undertakings
52 Loans secured by policies of insurance issued by the insurer
53 Other loans

Schedule 3: Asset item CIII 5.

Valuation rule: Investments (GENPRU 1.3.41R).

Admissibility: (1)(A)(b).

Restriction: None for line 51 items to the extent that these represent approved securities (INSPRU 2.1.33R(8)) nor for line 52 items (INSPRU 2.1.33R(3)). Line 53 items will be restricted to ¼% of the business amount for individuals (INSPRU 2.1.22R(3)(c)(i)) unless some special status applies to the counterparty (5%/10% for an approved counterparty, 2½% for a regulated institution) or debt (5% for a non-approved counterparty if the debt is secured).

Bank and approved credit & financial institution deposits

54 One month or less withdrawal
55 More than one month withdrawal

Schedule 3: Asset item CIII 6. Sums deposited with no time restriction are shown at asset item FIII even if they bear interest and will appear in line 81 on Form 13. The analysis between lines 54 and 55 is based on the position at the end of the financial year rather than the date on which the deposits were originally made.

Valuation rule: GAAP (GENPRU 1.3.4R).

Admissibility: (1)(B)(b).

Restriction: None in the case of a deposit with an approved financial institution since this represents an approved security (INSPRU 2.1.33R(8)). Deposits with approved credit institutions are subject to the overall restriction for an approved counterparty to 20% of the business amount or £2 million if higher (INSPRU 2.1.22R(3)(b)(ii)); however there is a more restrictive limit of 5%/10% of the business amount applying to all exposure other than short term deposits (INSPRU 2.1.22R(3)(b)(i)). Line 55 items would fall within this test but line 54 items would not.

56 Other financial investments

Schedule 3: Asset item CIII 7. It would appear to be logical to include deposits with “non-approved” credit institutions excluded from lines 54 and 55 at this line.

Valuation rule: Investments (GENPRU 1.3.41R). Admissibility: Depends upon the nature of the investment.

Restriction: Depends upon the nature of the item.

57 Deposits with ceding undertakings

Schedule 3: Asset item CIV. For an insurer accepting reinsurance this represents amounts owned by the ceding undertakings and corresponding to guarantees which are deposited with those ceding undertakings or with third parties or which are retained by those undertakings. These amounts may not be combined with other amounts owed by the ceding insurer to the reinsurer or set off against amounts owed by the reinsurer to the ceding insurer. Amounts at line 81 will also need to be taken into account when determining whether this test is met.
insurer. Securities deposited with ceding undertakings or third parties, which remain the property of the insurer, are excluded and appear under an appropriate investment heading.

Valuation rule: GAAP (GENPRU 1.3.4R). Note that GAAP may require recognition of an embedded derivative, in which case the rule for that element would be as for investments (GENPRU 1.3.41R).

Admissibility: (1)(B)(b).

Restriction: None if the deposit can legitimately be regarded as a premium withheld on agreed terms (which is in substance what such a deposit would normally be). In any event, the exposure arising may be offsettable under GAAP against the technical obligations that it exists to secure (which is the whole point, from the perspective of the cedant, of retaining the deposit in the first place). The situation may be more complicated where funds are deposited back rather than withheld, and conditions for offset under GAAP are not met; in which case counterparty restrictions may apply.

Assets held to match linked liabilities

58 Index-linked
59 Property-linked

Schedule 3: Asset item D. The distinction between index-linked benefits and property-linked benefits is discussed in chapter 8. Assets matching liabilities falling within the definition are included at these lines rather than at the more specific lines elsewhere on the Form relating to non-linked assets.

Valuation rule: GAAP (GENPRU 1.3.4R) or Investments (GENPRU 1.3.41R), depending upon the assets held.

Admissibility: None (GENPRU 2.2.251R).

Restriction: None (INSPRU 2.1.33R(6)), except for assets held to cover guarantees of investment performance or other guaranteed benefit, for which the normal counterparty limits would apply.

Reinsurers’ share of technical provisions

60 Provision for unearned premiums
61 Claims outstanding
62 Provision for unexpired risks
63 Other

Schedule 3: Asset item Da. Under Schedule 3 there is an option to show the reinsurance amounts either as asset item Da or as deductions from gross technical provisions on the liabilities side of the balance sheet (although the latter method appears to contravene FRS 5). For general insurance business it is now mandatory in the return to gross up and show these items as assets. These lines do not apply to long-term insurance business.

Valuation rule: GAAP (GENPRU 1.3.4R).

Admissibility: (1)(B)(a).

Restriction: None (INSPRU 2.1.34R).
Direct insurance business debtors

71 Policyholders
72 Intermediaries

Schedule 3: Asset item EI 1 and 2.

Valuation rule: GAAP (GENPRU 1.3.4R).

Admissibility: (1)(B)(c), save that premiums more than three months overdue are inadmissible.

Restriction: None (INSPRU 2.1.33R(2)).

73 Salvage and subrogation recoveries

Schedule 3: Asset item FV (“other” assets). Under Schedule 3 there is an option to deduct this from the provision for claims outstanding with note disclosure if material. Whichever treatment is adopted in the accounts should be followed in the return.

Valuation rule: GAAP (GENPRU 1.3.4R).

Admissibility: (1)(B)(d), for general insurance business only.

Restriction: None (INSPRU 2.1.33R(4)).

Reinsurance debtors

74 Accepted
75 Ceded

Schedule 3: Asset item EII.

Valuation rule: GAAP (GENPRU 1.3.4R).

Admissibility: (1)(B)(c) and (1)(B)(a), but under (1)(B)(c) premiums more than three months overdue are inadmissible.

Restriction: None (INSPRU 2.1.33R(2) and 3.2.34R).

Other debtors

76 Dependents - due in 12 months or less
77 Dependents - due in more than 12 months
78 Other - due in 12 months or less
79 Other - due in more than 12 months

Schedule 3: Asset item E III. The accounts are required to show amounts owed by group undertakings and undertakings in which the insurer has a participating interest as sub-items, although the definition of “dependant” is somewhat narrower.

Valuation rule: Debts due from dependants will be included at book value (GENPRU 1.3.44G), loans treated as investments and other items valued under GAAP (GENPRU 1.3.4R).

Admissibility: Other debts do not appear on the list of admissible assets in Annex 7R to GENPRU 2 (other than amounts owed arising from the disposal of investments, tax recoveries and claims against compensation funds). Other debts may be admissible if they represent loans, accrued income or prepayments.
Restriction: None directly for dependants, as these fall outside the Handbook glossary definition of “counterparty”, or for debts due from a Zone A country (INSRU 2.1.33R(7)). Other debts will be restricted by reference to the appropriate INSPRU 2.1.22R(3) counterparty limit, as discussed in chapter 4.

80  Tangible assets
Schedule 3: Asset item F1 (likely to be restricted to 1 and 2).

Valuation rule: GAAP (GENPRU 1.3.4R).

Admissibility: (1)(C)(a).

Restriction: None.

81  Deposits not subject to time restriction on withdrawal, with approved institutions

82  Cash in hand

Schedule 3: Asset item FIII, although this will extend to deposits with credit institutions outside the definition of “approved credit institutions”.

Valuation rule: GAAP (GENPRU 1.3.4R).

Admissibility: (1)(C)(b).

Restriction: None for deposits with approved financial institutions or with local authorities (assuming these are within Zone A) as these represent approved securities (INSRU 2.1.33R(8)). Deposits with approved credit institutions are restricted as described in relation to lines 54 and 55 above. Cash in hand is restricted to 3% of the business amount (INSRU 2.1.22R(3)(g)).

83  Other assets
Schedule 3: Asset item FV (which may also include salvage and subrogation recoveries). It would be logical to include at this line deposits with “non-approved” credit institutions excluded from line 81.

Valuation rule: This depends upon the asset in question. In view of the prescriptive list of admissible assets in Annex 7R to GENPRU 2, it will be rare to have entries at this line and a supplementary note (1315/1317) is required to give particulars.

Admissibility: Depends upon the specific asset.

Restriction: Again this depends upon the nature of the asset.

84  Accrued interest and rent
Schedule 3: Asset item GI (which relates to interest and rent that have been earned up to the balance sheet date but have not yet become receivable).

Valuation rule: GAAP (GENPRU 1.3.4R).

Admissibility: (1)(C)(d).

Restriction: None if representing approved securities or amounts due from Zone A governments (INSRU 2.1.33R(8))\(^\text{173}\). Otherwise as for debts (see lines 76 to 79). Interest

\(^{173}\) Prior to the introduction of PRU, rule 4.14 of IPRU(INS) explicitly exempted interest accrued on approved securities; although the present rule does not say this, such accrued interest is likely to be exempted anyway.
that has been capitalised into the parent instrument should be considered according to the rule for that instrument.

85 Deferred acquisition costs
Schedule 3: Asset item GII.

Valuation rule: GAAP (GENPRU 1.3.4R).

Admissibility: (1)(C)(c) for general insurance business only. Inadmissible for long-term insurance business.

Restriction: None (INSPRU 2.1.33R(5)).

86 Other prepayments and accrued income
Schedule 3: Asset item GIII.

Valuation rule: GAAP (GENPRU 1.3.4R).

Admissibility: (1)(C)(d).

Restriction: If a prepayment gives rise to a counterparty exposure, it would be restricted in a similar way to a debt.

87 Deductions from the aggregate value of assets
This only needs to be completed where:

a) a restriction arises by virtue of the aggregate counterparty exposure limits of paragraphs (d), (e) and (f) of INSPRU 2.1.22R(3); or

b) there is deemed exposure arising under a derivative contract that exceeds the amount in the relevant line of Form 13.
Appendix B  Supplementary Notes

This appendix provides a checklist of the supplementary notes required by the Accounts and Statements Rules in respect of the Appendix 9.1, 9.2 or 9.3 Forms, the four digit code allocated, the reference in the main text of the booklet and the source in IPRU(INS).

The majority of the notes are required on an exception reporting basis; however, the following would normally be expected to be present whenever a given Form is prepared:

0301, 0313, 1305/1319, 1401, 1402, 1501, 1502, 1601 (unless all business is denominated in sterling), 20Ae (unless the insurer only writes treaty business), 20Ag (unless there are no premiums), 2102, 2202, 2204, 2402, 2404, 2406, 2501, 3001, 3003, 4005 (if there is no Form 16), 4006 (if there is more than one Form 40) and 4401.

The prescribed four character code should appear as the first element of the title that is given to a supplementary note. Two or more supplementary notes should not be combined as a single text with a single title except where this avoids unnecessary repetition or leads to a clearer explanation. Where alternative supplementary note numbers are shown in respect of Form 13, the first number relates to other than long-term insurance business and the number in parentheses to long-term insurance business.

There are various gaps in the numbering sequence, reflecting the fact that where particular supplementary notes have been deleted or transferred to other Forms (e.g. from Form 20 to Form 20A), the subsequent notes have not been renumbered. The now redundant notes 1103 and 1203 (Instruction 9 to Forms 11 and 12), of relevance only to financial years commencing before 1 January 2005, are omitted from the table below.

Many supplementary note requirements are set out in the Instructions to a given Form, and the IPRU(INS) reference given below, where it is to an Instruction, is to the Instructions for the Form to which the supplementary note relates unless stated otherwise; an exception is made for Forms 11 and 12 where, as there are combined Instructions for Forms 11 and 12 as well as separately numbered Instructions for each of these two Forms, the specific Instructions are identified. Forms 51 to 54 have a single set of combined Instructions.

As the descriptions below are a summary, reference should always be had to the Handbook source requirement.

<table>
<thead>
<tr>
<th>Code</th>
<th>Description</th>
<th>Booklet reference</th>
<th>IPRU(INS) reference</th>
</tr>
</thead>
<tbody>
<tr>
<td>FF00</td>
<td>Form omitted because all entries (including comparatives) would be blank or because of the operation of the de minimis limits</td>
<td>chapter 2, paragraph 4.12</td>
<td>Rule 9.11</td>
</tr>
</tbody>
</table>
| 0101   | Waiver issued disapplying or modifying any of the provisions of the Accounts and Statements Rules in respect of general insurance business  

[Note Section 68 Orders are no longer relevant under the new PRA regime].                                                                                                                                                                                                 |
<p>|        | chapter 2, paragraph 2.9                                                                                                                                                                                  | Instruction 22                      |                     |
| 0102   | The allocation in the branch return of a composite of any excess or deficiency of available capital resources to cover the guarantee fund between general and long-term insurance business                                          | chapter 3, paragraph 2.29           | Instruction 7        |</p>
<table>
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<tr>
<th>Code</th>
<th>Description</th>
<th>Booklet reference</th>
<th>IPRU(INS) reference</th>
</tr>
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<tr>
<td>0111</td>
<td>Any restatement of comparatives on Form 1 chapter 2, paragraph 4.13</td>
<td>Appendix 9.1</td>
<td></td>
</tr>
<tr>
<td>0201</td>
<td>Waiver issued disapplying or modifying any of the provisions of the Accounts and Statements Rules in respect of long-term insurance business [Note Section 68 Orders are no longer relevant under the new PRA regime].</td>
<td>Instruction 25</td>
<td></td>
</tr>
<tr>
<td>0202</td>
<td>An analysis of Form 2 line 11 for a branch which has an implicit item chapter 3, paragraph 2.26</td>
<td>Instruction 2</td>
<td></td>
</tr>
<tr>
<td>0203</td>
<td>In a branch return, the adjustments made in arriving at Form 2 line 22 chapter 3, paragraph 2.29</td>
<td>Instruction 6</td>
<td></td>
</tr>
<tr>
<td>0211</td>
<td>Any restatement of comparatives on Form 2 chapter 2, paragraph 4.13 Appendix 9.1 paragraph 7</td>
<td>Instruction 25</td>
<td></td>
</tr>
<tr>
<td>0301</td>
<td>A reconciliation of net admissible assets to total capital resources after deductions chapter 3, paragraph 2.21</td>
<td>Instruction 66</td>
<td></td>
</tr>
<tr>
<td>0302</td>
<td>An analysis of instruments issued by the long-term insurance fund included within capital resources chapter 3, paragraph 2.2</td>
<td>Instruction 2</td>
<td></td>
</tr>
<tr>
<td>0303</td>
<td>Any material change from one year to the next in the way that a composite firm allocates capital items arising outside the long-term insurance business amount between general insurance business and long-term insurance business chapter 3, paragraph 2.2</td>
<td>Instruction 4</td>
<td></td>
</tr>
<tr>
<td>0304</td>
<td>Any entries at line 42 or 43 relating to amounts excluded from lines 26 and 28 chapter 3, paragraph 2.12 and chapter 10, paragraph 2.11</td>
<td>Instruction 38</td>
<td></td>
</tr>
<tr>
<td>0305</td>
<td>Information about any arrangement not entered in lines 91 to 95 which falls within the definition of a financing arrangement in paragraph 9(3) of Appendix 9.4 (Abstract of valuation report) chapter 3, paragraph 2.19</td>
<td>Instruction 58</td>
<td></td>
</tr>
<tr>
<td>0306</td>
<td>Information about each material financial reinsurance ceded disclosed in line 92 for long-term insurance business chapter 3, paragraph 2.19</td>
<td>Instruction 60</td>
<td></td>
</tr>
<tr>
<td>0307</td>
<td>Information about each material financial reinsurance accepted disclosed in line 93 for long-term insurance business chapter 3, paragraph 2.19</td>
<td>Instruction 61</td>
<td></td>
</tr>
<tr>
<td>Code</td>
<td>Description</td>
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<tr>
<td>0308</td>
<td>Information about adjustments for contingent loans and for other charges on future profits shown in lines 94 and 95, including the commutation value for each major arrangement</td>
<td>chapter 3, paragraph 2.19</td>
<td>Instruction 64</td>
</tr>
<tr>
<td>0309</td>
<td>Details of any promises to policy holders conditional upon future profits and of any other charges to future profits not already disclosed</td>
<td>chapter 3, paragraph 2.20</td>
<td>Instruction 65</td>
</tr>
<tr>
<td>0310</td>
<td>Details of positive and negative valuation differences shown in lines 14 and 35 between the return and the values used for external financial reporting purposes</td>
<td>chapter 3, paragraphs 2.7 and 2.8 and chapter 4 paragraph 2.10</td>
<td>Instruction 9</td>
</tr>
<tr>
<td>0311</td>
<td>Any restatement of comparatives on Form 3 (not due solely to currency retranslation – see 1602)</td>
<td>chapter 2, paragraph 4.13</td>
<td>Appendix 9.1 paragraph 7</td>
</tr>
<tr>
<td>0312</td>
<td>Waiver issued permitting an insurer to take into account implicit items for long-term insurance business</td>
<td>chapter 3, paragraph 2.15</td>
<td>Instruction 67</td>
</tr>
<tr>
<td>0313</td>
<td>A reconciliation of the movement in profit and loss account and other reserves between columns 3 and 4 of Form 3 line 12 to the profit and loss retained per Form 16 line 59</td>
<td>chapter 3 paragraph 2.23</td>
<td>Instruction 68</td>
</tr>
<tr>
<td>1002</td>
<td>Particulars of any other movements at Form 10 line 65</td>
<td>chapter 3, paragraph 2.24</td>
<td>Instruction 5</td>
</tr>
<tr>
<td>1011</td>
<td>Any restatement of comparatives or brought forward figures on Form 10 (not due solely to currency retranslation – see 1602)</td>
<td>chapter 2, paragraph 4.13</td>
<td>Appendix 9.1 paragraph 7</td>
</tr>
<tr>
<td>1101</td>
<td>The bases of conversion used by a marine mutual completing an abridged return</td>
<td>appendix F, paragraph 11</td>
<td>Instruction 4 to Forms 11 and 12</td>
</tr>
<tr>
<td>1102</td>
<td>Any restatement of the figures in column 2 because of the requirement to recalculate the gross adjusted premiums amount because there has been a significant change to the business portfolio</td>
<td>chapter 3, paragraph 3.16</td>
<td>Instruction 6 to Forms 11 and 12</td>
</tr>
<tr>
<td>1104</td>
<td>Any discounting adjustments included at Form 11 line 51</td>
<td>chapter 3, paragraph 3.9</td>
<td>Instruction 3 to Form 11</td>
</tr>
<tr>
<td>1105</td>
<td>The amount of, and an explanation of, any differences between amounts on Form 11 and the corresponding amounts on Forms 21 to 25</td>
<td>chapter 3, paragraph 3.15</td>
<td>Appendix 9.1 paragraph 10(2)</td>
</tr>
<tr>
<td>Code</td>
<td>Description</td>
<td>Booklet reference</td>
<td>IPRU(INS) reference</td>
</tr>
<tr>
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</tr>
<tr>
<td>1111</td>
<td>Any restatement of comparatives or brought forward figures on Form 11 (not due solely to currency retranslation – see 1602)</td>
<td>chapter 2, paragraph 4.13 and chapter 3, paragraph 3.16</td>
<td>Appendix 9.1 paragraph 7</td>
</tr>
<tr>
<td>1202</td>
<td>Any restatement of the figures in column 2 because of the requirement to recalculate the gross adjusted claims amount because there has been a significant change to the business portfolio</td>
<td>chapter 3, paragraph 3.16</td>
<td>Instruction 6 to Forms 11 and 12</td>
</tr>
<tr>
<td>1205</td>
<td>The amount of, and an explanation of, any differences between amounts on Form 12 and the corresponding amounts on Forms 21 to 25</td>
<td>chapter 3, paragraph 3.15</td>
<td>Appendix 9.1 paragraph 10(2)</td>
</tr>
<tr>
<td>1211</td>
<td>Any restatement of comparatives or brought forward figures on Form 12 (not due solely to currency retranslation – see 1602)</td>
<td>chapter 2, paragraph 4.13 and chapter 3, paragraph 3.16</td>
<td>Appendix 9.1 paragraph 7</td>
</tr>
<tr>
<td>1301</td>
<td>The aggregate value of certain specific types of asset together with a description of the assets in question</td>
<td>chapter 4, paragraph 1.14</td>
<td>Instruction 5</td>
</tr>
<tr>
<td>1302</td>
<td>The aggregate value of hybrid securities included in lines 46 or 48.</td>
<td>chapter 4, paragraph 1.14</td>
<td>Instruction 6</td>
</tr>
<tr>
<td>1303</td>
<td>The amounts of any salvage or subrogation recoveries included other than in debtors at line 73.</td>
<td>chapter 4, paragraph 1.14</td>
<td>Instruction 7</td>
</tr>
<tr>
<td>1304</td>
<td>A statement that amounts have been set off to the extent permitted by generally accepted accounting principles, if this option has been exercised</td>
<td>chapter 4, paragraph 1.16</td>
<td>Appendix 9.1 paragraph 8(3)</td>
</tr>
<tr>
<td>1305</td>
<td>The maximum counterparty limit permitted by the insurer’s investment guidelines together with an account of any breaches</td>
<td>chapter 4, paragraph 4.25</td>
<td>Appendix 9.1 paragraph 11(1)</td>
</tr>
<tr>
<td>1306</td>
<td>The amount and nature of large exposures to counterparties at the year end</td>
<td>chapter 4, paragraph 4.27</td>
<td>Appendix 9.1 paragraph 11(2)</td>
</tr>
<tr>
<td>1307</td>
<td>The aggregate value of certain fully secured rights</td>
<td>chapter 4, paragraph 4.28</td>
<td>Appendix 9.1 paragraph 11(3)</td>
</tr>
<tr>
<td>1308</td>
<td>see 1301</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1309</td>
<td>see 1302</td>
<td></td>
<td></td>
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<td>1310</td>
<td>see 1304</td>
<td></td>
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<td>IPRU(INS) reference</td>
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</tr>
<tr>
<td>1311</td>
<td>Any restatement of comparatives on Form 13 (not solely due to currency retranslation – see 1602).</td>
<td>chapter 2, paragraph 4.13</td>
<td>Appendix 9.1 paragraph 7</td>
</tr>
<tr>
<td>1312</td>
<td>see 1306</td>
<td></td>
<td></td>
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<tr>
<td>1313</td>
<td>see 1307</td>
<td></td>
<td></td>
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<tr>
<td>1314</td>
<td>The amount of any tangible leased assets included at Form 13 line 80</td>
<td>chapter 4, paragraph 1.17</td>
<td>Instruction 14</td>
</tr>
<tr>
<td>(1316)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1315</td>
<td>Particulars of any “other assets” included at Form 13 line 83</td>
<td>chapter 4, paragraph 1.17</td>
<td>Instruction 15</td>
</tr>
<tr>
<td>(1317)</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>1316</td>
<td>see 1314</td>
<td></td>
<td></td>
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<td>1317</td>
<td>see 1315</td>
<td></td>
<td></td>
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<tr>
<td>1318</td>
<td>Details of “other asset adjustments” included at Form 13 line 101</td>
<td>chapter 4, paragraph 1.18</td>
<td>Instruction 16</td>
</tr>
<tr>
<td>1319</td>
<td>see 1305</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1320</td>
<td>The amount in lines 60 to 62 recoverable from Insurance Special Purpose Vehicles</td>
<td>chapter 7, paragraph 6.6</td>
<td>Instruction 11</td>
</tr>
<tr>
<td>1401</td>
<td>The methods and assumptions used to determine the amount of any provision for reasonably foreseeable adverse variations or valuation adjustments, or if there is no provision the methods and assumptions used to determine that no provision is required</td>
<td>chapter 4, paragraphs 2.10 to 2.12, chapter 4, paragraph 5.15 and chapter 5, paragraph 1.8</td>
<td>Appendix 9.1 paragraph 12</td>
</tr>
<tr>
<td>1402</td>
<td>Details of charges over assets, potential capital gains tax liabilities, contingent liabilities, guarantees, indemnities or other contractual commitments effected other than in the ordinary course of business and in respect of related companies and any other fundamental uncertainties</td>
<td>chapter 5, paragraph 3.2</td>
<td>Appendix 9.1 paragraph 13(1)</td>
</tr>
<tr>
<td>1403</td>
<td>Any provision for a deficit in a regulated related undertaking included at line 22 of Form 14 and the identity of the undertaking</td>
<td>chapter 4, paragraph 2.17</td>
<td>Instruction 9</td>
</tr>
<tr>
<td>1404</td>
<td>Any implicit provision set up to cover an obligation to pay a monetary amount under INSPRU 3.2.17R(3) (provision for reasonably foreseeable adverse variations).</td>
<td>chapter 4, paragraph 5.13</td>
<td>Instruction 6</td>
</tr>
<tr>
<td>1405</td>
<td>Details of “other adjustments to liabilities” included at Form 14 line 74 of the reconciliation to the financial statements</td>
<td>chapter 5, paragraph 2.20</td>
<td>Instruction 8</td>
</tr>
<tr>
<td>Code</td>
<td>Description</td>
<td>Booklet reference</td>
<td>IPRU(INS) reference</td>
</tr>
<tr>
<td>------</td>
<td>-----------------------------------------------------------------------------</td>
<td>-------------------</td>
<td>-----------------------------</td>
</tr>
<tr>
<td>1406</td>
<td>The amount of any increase or decrease in the value of non-linked assets in respect of the Form 14 prepared for a with-profits fund</td>
<td>chapter 5, paragraph 1.5</td>
<td>Rule 9.12(6)(c)</td>
</tr>
<tr>
<td>1411</td>
<td>Any restatement of comparatives on Form 14 (not solely due to currency retranslation – see 1602).</td>
<td>chapter 2, paragraph 4.13</td>
<td>Appendix 9.1 paragraph 7</td>
</tr>
<tr>
<td>1501</td>
<td>The methods and assumptions used to determine the amount of any provision for reasonably foreseeable adverse variations or valuation adjustments, or if there is no provision the methods and assumptions used to determine that no provision is required</td>
<td>chapter 4, paragraphs 2.10 to 2.12, chapter 4, paragraph 5.15 and chapter 5, paragraph 2.2</td>
<td>Appendix 9.1 paragraph 12</td>
</tr>
<tr>
<td>1502</td>
<td>Details of charges over assets, potential capital gains tax liabilities, contingent liabilities, guarantees, indemnities or other contractual commitments effected other than in the ordinary course of business and in respect of related companies and any other fundamental uncertainties.</td>
<td>chapter 5, paragraph 3.2</td>
<td>Appendix 9.1 paragraph 13(1)</td>
</tr>
<tr>
<td>1503</td>
<td>The aggregate amount of any accrued dividend in respect of cumulative preference shares issued by the insurer</td>
<td>chapter 5, paragraph 2.13</td>
<td>Instruction 2</td>
</tr>
<tr>
<td>1504</td>
<td>Any provision for a deficit in a regulated related undertaking included at line 22 of Form 15 and the identity of the undertaking</td>
<td>chapter 4, paragraph 2.17</td>
<td>Instruction 5</td>
</tr>
<tr>
<td>1506</td>
<td>Any implicit provision set up to cover an obligation to pay a monetary amount under INSPRU 3.2.17R(3) (provision for reasonably foreseeable adverse variations).</td>
<td>chapter 4, paragraph 5.13</td>
<td>Instruction 6</td>
</tr>
<tr>
<td>1507</td>
<td>Details of “other adjustments to liabilities” included at Form 15 line 83</td>
<td>chapter 5, paragraph 2.20</td>
<td>Instruction 8</td>
</tr>
<tr>
<td>1511</td>
<td>Any restatement of comparatives on Form 15 (not solely due to currency retranslation – see 1602).</td>
<td>chapter 2, paragraph 4.13</td>
<td>Appendix 9.1 paragraph 7</td>
</tr>
<tr>
<td>1601</td>
<td>The bases of conversion adopted in respect of foreign currency for income and expenditure</td>
<td>chapter 2, paragraph 4.10</td>
<td>Appendix 9.1 paragraph 5(2) and Instruction 1</td>
</tr>
<tr>
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<td>Description</td>
<td>Booklet reference</td>
<td>IPRU(INS) reference</td>
</tr>
<tr>
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<tr>
<td>1602</td>
<td>Differences in brought forward figures because of currency retranslation</td>
<td>chapter 6, paragraph 1.10</td>
<td>Instruction 1</td>
</tr>
<tr>
<td></td>
<td>[This note, rather than the “11” notes, is appropriate where the only reason for differences in brought forward figures is exchange rate movements.]</td>
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<tr>
<td>1603</td>
<td>Other income and charges included at Form 16 line 21</td>
<td>chapter 6, paragraph 1.6</td>
<td>Instruction 2</td>
</tr>
<tr>
<td>1604</td>
<td>Extraordinary profit or loss included at Form 16 line 41</td>
<td>chapter 6, paragraph 1.7</td>
<td>Instruction 3</td>
</tr>
<tr>
<td>1611</td>
<td>Any restatement of comparatives on Form 16 (not solely due to currency retranslation – see 1602).</td>
<td>chapter 2, paragraph 4.13</td>
<td>Appendix 9.1 paragraph 7</td>
</tr>
<tr>
<td>1701</td>
<td>Prescribed details of variation margin</td>
<td>chapter 4, paragraph 5.29</td>
<td>Appendix 9.1 paragraph 16</td>
</tr>
<tr>
<td>1702</td>
<td>Holdings of quasi-derivatives in excess of the materiality threshold</td>
<td>chapter 4, paragraph 5.30</td>
<td>Appendix 9.1 paragraph 17</td>
</tr>
<tr>
<td>1811</td>
<td>Any restatement of comparatives on Forms 18 or 19 respectively (not solely due to currency retranslation – see 1602).</td>
<td>chapter 2, paragraph 4.13</td>
<td>Appendix 9.1 paragraph 7</td>
</tr>
<tr>
<td>20Aa</td>
<td>Business allocated to a category under rule 9.14B</td>
<td>chapter 6, paragraph 2.5</td>
<td>Appendix 9.2 paragraph 7(1)(a)</td>
</tr>
<tr>
<td>20Ab</td>
<td>The risk categories to which any contracts of insurance against risks of death of, or injury to, passengers, have been allocated</td>
<td>chapter 6, paragraph 2.4</td>
<td>Appendix 9.2 paragraph 7(1)(b)</td>
</tr>
<tr>
<td>20Ac</td>
<td>A detailed explanation of business allocated to each of category numbers 187, 223, 400 or 700</td>
<td>chapter 6, paragraph 5.7</td>
<td>Appendix 9.2 paragraph 7(1)(c)</td>
</tr>
<tr>
<td>20Ad</td>
<td>The claims-made and non-claims-made elements of a risk category which contains both types of policy</td>
<td>chapter 6, paragraph 5.8</td>
<td>Appendix 9.2 paragraph 7(1)(d)</td>
</tr>
<tr>
<td>20Ae</td>
<td>The amounts reported on Form 20A in category 002 which are attributable to facultative reinsurance business</td>
<td>chapter 6, paragraph 2.18</td>
<td>Appendix 9.2 paragraph 7(1)(e)</td>
</tr>
<tr>
<td>20Af</td>
<td>The amounts reported in Form 20A under each of categories 113, 274 and 343 that have arisen from business falling within each group of classes in Annex 11.2 Part II and from classes 16, 17 and 18 combined</td>
<td>chapter 6, paragraph 5.8</td>
<td>Appendix 9.2 paragraph 7(1)(f)</td>
</tr>
<tr>
<td>Code</td>
<td>Description</td>
<td>Booklet reference</td>
<td>IPRU(INS) reference</td>
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<tr>
<td>20Ag</td>
<td>The home foreign and overseas elements of gross premiums for each risk category on Form 20A and (except for treaty business) a list of the overseas countries concerned. The concept of “home foreign” does not apply to MAT business or treaty reinsurance business accepted.</td>
<td>chapter 6, paragraph 5.4</td>
<td>Appendix 9.2 paragraph 16(1)</td>
</tr>
<tr>
<td>20Ah</td>
<td>Details of policies effected by another insurer which were transferred to the insurer during the financial year.</td>
<td>chapter 6, paragraph 2.18</td>
<td>Appendix 9.2 paragraph 17(1)</td>
</tr>
<tr>
<td>20Ai</td>
<td>Technical provisions on Form 20A relating to policies effected by another insurer which have been transferred to the insurer.</td>
<td>chapter 6, paragraph 2.18</td>
<td>Appendix 9.2 paragraph 17(3)</td>
</tr>
<tr>
<td>20Aj</td>
<td>For any general insurance business class where no new contracts of insurance were effected during the financial year, the date on which the last new contract of each class was effected.</td>
<td>chapter 2, paragraph 3.5</td>
<td>Appendix 9.2 paragraph 21(1)</td>
</tr>
<tr>
<td>20Ak</td>
<td>Details of inward or outward contracts of (re)insurance excluded from the revenue account Forms on the basis of GAAP</td>
<td>chapter 7, paragraph 3.2</td>
<td>Appendix 9.2 paragraph 26(2)</td>
</tr>
<tr>
<td>20Al</td>
<td>Any difference between Form 20A.1.1 and Form 11.11.1 or between Form 20A.1.4 and Form 15.11.1</td>
<td>chapter 6, paragraph 2.16</td>
<td>Instruction 7</td>
</tr>
<tr>
<td>2005</td>
<td>Particulars of any amounts included at lines 16, 25 or 32 of Form 20 as other technical income or charges</td>
<td>chapter 5, paragraph 2.11 and chapter 6, paragraphs 3.4 and 4.8</td>
<td>Instruction 1</td>
</tr>
<tr>
<td>2007</td>
<td>Brief details of any material connected party transaction required to be disclosed.</td>
<td>chapter 11, section 1</td>
<td>Rule 9.39(1)</td>
</tr>
<tr>
<td>2011</td>
<td>Any restatement of comparatives on Form 20 (not solely due to currency retranslation – see 1602).</td>
<td>chapter 2, paragraph 4.13</td>
<td>Appendix 9.2 paragraph 8A</td>
</tr>
<tr>
<td>2101</td>
<td>Any difference between unearned premiums brought forward and the corresponding amount carried forward in the previous return (not due solely to currency retranslation – see 1602)</td>
<td>chapter 6, paragraph 1.10</td>
<td>Appendix 9.2 paragraph 8A</td>
</tr>
<tr>
<td>2102</td>
<td>The basis on which the provision for unearned premiums is calculated and the reason for adopting that basis.</td>
<td>chapter 5, paragraph 2.5 and chapter 6, paragraph 3.5</td>
<td>Appendix 9.2 paragraph 18</td>
</tr>
<tr>
<td>Code</td>
<td>Description</td>
<td>Booklet reference</td>
<td>IPRU(INS) reference</td>
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<tr>
<td>2103</td>
<td>Any differences between Form 21 and Forms 13 and 15 as a result of the omission from Form 21 of premiums received during the financial year but relating to risks incepting after the end of the financial year</td>
<td>chapter 6, paragraph 3.7</td>
<td>Instruction 1</td>
</tr>
<tr>
<td>2201</td>
<td>Any difference between brought forward amounts on Form 22 and the corresponding carried forward amounts in the previous return (not due solely to currency retranslation – see 1602)</td>
<td>chapter 6, paragraph 1.10</td>
<td>Appendix 9.2 paragraph 8A</td>
</tr>
<tr>
<td>2202</td>
<td>The basis for determining claims management expenses payable and carried forward, including an explanation of the absence of claims management expenses carried forward where there are claims outstanding carried forward and the basis of additional costs arising from the cessation of new business in any class</td>
<td>chapter 6, paragraph 3.12</td>
<td>Appendix 9.2 paragraph 22(1) – (3)</td>
</tr>
<tr>
<td>2203</td>
<td>Rates of interest and average interval assumed for any class where investment income has been taken into account in determining the claims management costs carried forward</td>
<td>chapter 6, paragraph 3.13</td>
<td>Appendix 9.2 paragraph 22(4)</td>
</tr>
<tr>
<td>2204</td>
<td>The basis for determining acquisition costs other than commission payable and carried forward</td>
<td>chapter 6, paragraph 3.16</td>
<td>Appendix 9.2 paragraph 23</td>
</tr>
<tr>
<td>2205</td>
<td>Where investment income has been taken into account in determining the provision for unexpired risks, the undiscounted provision, the rates of investment return assumed and the average interval from the end of the financial year to the date at which claims are expected to be settled in cash</td>
<td>chapter 6, paragraph 3.15</td>
<td>Appendix 9.2 paragraph 20(1)</td>
</tr>
<tr>
<td>2206</td>
<td>Where the reinsurers’ share of claims incurred (as stated in any Form 22 or 25) includes amounts expected to be recovered from reinsurers more than 12 months after the payment of the underlying gross claims, the amount of such recoveries and the accounting treatment which has been adopted in respect of discounting such recoveries</td>
<td>chapter 5, paragraph 4.7 and chapter 7, paragraph 3.3</td>
<td>Appendix 9.2 paragraph 28</td>
</tr>
<tr>
<td>2301</td>
<td>Any difference between brought forward amounts on Forms 23 and 24 respectively and the corresponding carried forward amounts in the previous return (not due solely to currency retranslation – see 1602)</td>
<td>chapter 6, paragraph 1.10</td>
<td>Appendix 9.2 paragraph 8A</td>
</tr>
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<td>Code</td>
<td>Description</td>
<td>Booklet reference</td>
<td>IPRU(INS) reference</td>
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<tr>
<td>2402</td>
<td>Details relating to the adoption of underwriting year accounting (and, historically, the non-annual method of determining the provision for claims outstanding where this was used, though this part of the disclosure is no longer expected to be encountered in practice)</td>
<td>chapter 6, paragraph 4.6</td>
<td>Appendix 9.2 paragraph 24(1)</td>
</tr>
<tr>
<td>2404</td>
<td>The basis for determining claims management expenses payable and carried forward, including an explanation of the absence of claims management expenses carried forward where there are claims outstanding carried forward and the basis of additional costs arising from the cessation of new business in any class</td>
<td>chapter 6, paragraph 4.11</td>
<td>Appendix 9.2 paragraph 22(1)</td>
</tr>
<tr>
<td>2405</td>
<td>Rates of interest and average interval assumed for any class where investment income has been taken into account in determining the claims management costs carried forward</td>
<td>chapter 6, paragraph 4.11</td>
<td>Appendix 9.2 paragraph 22(4)</td>
</tr>
<tr>
<td>2406</td>
<td>The basis for determining acquisition costs other than commission payable and carried forward</td>
<td>chapter 6, paragraph 4.11</td>
<td>Appendix 9.2 paragraph 23</td>
</tr>
<tr>
<td>2501</td>
<td>The basis on which the provision for unearned premiums is calculated and the reason for adopting that basis</td>
<td>chapter 5, paragraph 2.5 and chapter 6, paragraph 4.11</td>
<td>Appendix 9.2 paragraph 18</td>
</tr>
<tr>
<td>2502</td>
<td>Where investment income has been taken into account in determining the provision for unexpired risks, the undiscounted provision, the rates of investment return and the average interval from the end of the financial year to the date at which claims are expected to be settled in cash</td>
<td>chapter 6, paragraph 4.11</td>
<td>Appendix 9.2 paragraph 20(1)</td>
</tr>
<tr>
<td>2503</td>
<td>Where the reinsurers’ share of claims incurred includes amounts expected to be recovered from reinsurers more than 12 months after the payment of the underlying gross claims, the amount of such recoveries and the accounting treatment which has been adopted in respect of discounting such recoveries</td>
<td>chapter 5, paragraph 4.7 and chapter 7, paragraph 3.3</td>
<td>Appendix 9.2 paragraph 28</td>
</tr>
<tr>
<td>Code</td>
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<td>Booklet reference</td>
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<tr>
<td>2504</td>
<td>Where a surplus for offset is shown at line 19 of Form 25, a description of the business for which the anticipated surplus and deficit arose and the reason for treating the business as managed together (NB: this note is not expected to be present as profit deferral is no longer permitted, and line 19 should always be blank)</td>
<td>chapter 6, paragraph 4.11</td>
<td>Appendix 9.2 paragraph 25(2)</td>
</tr>
<tr>
<td>2505</td>
<td>Particulars of any “other” technical provisions at line 25 of Form 25</td>
<td>chapter 5, paragraph 2.11 and chapter 6, paragraph 4.11</td>
<td>Instruction 8</td>
</tr>
<tr>
<td>2601</td>
<td>Any difference between brought forward amounts on Forms 26, 27, and 28 respectively, and the corresponding carried forward amounts in the previous return (not due solely to currency retranslation – see 1602)</td>
<td>chapter 6, paragraph 1.10</td>
<td>Appendix 9.2 paragraph 8A</td>
</tr>
<tr>
<td>2901</td>
<td>Where a surplus for offset is shown at line 19 of Form 29, a description of the business for which the anticipated surplus and deficit arose and the reason for treating the business as managed together (NB: this note is not expected to be present as profit deferral is no longer permitted, and line 19 should always be blank)</td>
<td>chapter 6, paragraph 6.2</td>
<td>Appendix 9.2 paragraph 25(2)</td>
</tr>
<tr>
<td>2902</td>
<td>Particulars of “other” technical provisions stated at line 25 of Form 29</td>
<td>chapter 6, paragraph 6.2</td>
<td>Rubric of line 25</td>
</tr>
<tr>
<td>3001</td>
<td>The methods and assumptions used in determining the yield in accordance with Instruction 4 to Form 30</td>
<td>chapter 5, paragraph 4.6</td>
<td>Instruction 5</td>
</tr>
<tr>
<td>3002</td>
<td>The treatment of expected income payments (in arriving at the amounts shown at columns 3 and 4 of Form 30) from any asset where such payment is in default</td>
<td>chapter 5, paragraph 4.6</td>
<td>Instruction 7</td>
</tr>
<tr>
<td>3003</td>
<td>The risk categories where an adjustment for discounting has been made with disclosure for each category of the method, rate of interest, expected average interval to the settlement date and the criteria adopted for estimating the period that will elapse before claims are settled</td>
<td>chapter 5, paragraph 4.6</td>
<td>Appendix 9.2 paragraph 27(5)</td>
</tr>
<tr>
<td>Code</td>
<td>Description</td>
<td>Booklet reference</td>
<td>IPRU(INS) reference</td>
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<tr>
<td>3101</td>
<td>Any difference between brought forward amounts on Forms 31, 32 and 34</td>
<td>chapter 6, paragraph 1.10</td>
<td>Appendix 9.2 paragraph 8A</td>
</tr>
<tr>
<td>3201</td>
<td>respectively, and the corresponding carried forward amounts in the previous return (not due solely to currency retranslation – see 1602)</td>
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<td>3401</td>
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<tr>
<td>4001</td>
<td>Any difference between brought forward amounts on Form 40 and the corresponding carried forward amounts in the previous return (not due solely to currency retranslation – see 1602)</td>
<td>chapter 8, paragraph 1.7</td>
<td>Instruction 13</td>
</tr>
<tr>
<td>4002</td>
<td>Particulars of the amounts included at lines 15 and 25 of Form 40 for “other income” and “other expenditure”</td>
<td>chapter 8, paragraph 1.11</td>
<td>Instruction 4</td>
</tr>
<tr>
<td>4003</td>
<td>If an insurer decides to allocate to the long-term insurance business the whole or any part of investment income and/or net capital gains arising from assets not attributable to its long-term insurance business, the amount of the allocation included at Form 40 line 26</td>
<td>chapter 8, paragraph 1.3</td>
<td>Instruction 5</td>
</tr>
<tr>
<td>4004</td>
<td>Details of transfers of contracts to or from another fund or another insurer included in line 31 or 32.</td>
<td>chapter 8, paragraph 1.10</td>
<td>Instruction 12</td>
</tr>
<tr>
<td>4005</td>
<td>The basis of conversion adopted in respect of foreign currency for income and expenditure except where this has already been stated in a note to Form 16</td>
<td>chapter 2, paragraph 4.10</td>
<td>Appendix 9.1 paragraph 5(2) and Instruction 14</td>
</tr>
<tr>
<td>4006</td>
<td>Where an insurer maintains more than one long-term insurance business fund, the principles and methods applied to apportioning the investment income, the increase or decrease in the value of assets brought into account, expenses and taxation between the different funds</td>
<td>chapter 8, paragraph 1.8</td>
<td>Appendix 9.3 paragraph 4(1) and Instruction 15</td>
</tr>
<tr>
<td>4008</td>
<td>Where arrangements have been in force during the financial year for the provision either by or to the insurer of management services, a statement of the fact together with the name of the other party</td>
<td>chapter 8, paragraph 1.12</td>
<td>Appendix 9.3 paragraph 5 and Instruction 16</td>
</tr>
<tr>
<td>4009</td>
<td>Details of any material connected party transaction required to be disclosed</td>
<td>chapter 11, section 1</td>
<td>rule 9.39(1) and Instruction 17</td>
</tr>
<tr>
<td>4010</td>
<td>The amount, if any, of investment income relating to linked assets included at Form 40 line 12 for a with-profits fund</td>
<td>chapter 8, paragraph 1.8</td>
<td>rule 9.14</td>
</tr>
<tr>
<td>Code</td>
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<td>Booklet reference</td>
<td>IPRU(INS) reference</td>
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<tr>
<td>4011</td>
<td>Any restatement of comparatives on Forms 40, 41, 42 and 43 respectively (not solely due to currency retranslation – see 1602).</td>
<td>chapter 2, paragraph 4.13</td>
<td>Appendix 9.3 paragraph 2A</td>
</tr>
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<td>4111</td>
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<td>4211</td>
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<td>4311</td>
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<tr>
<td>4401</td>
<td>The basis on which linked assets have been valued</td>
<td>chapter 8, paragraph 2.16</td>
<td>Instruction 2</td>
</tr>
<tr>
<td>4402</td>
<td>The aggregate value of rights (gross of variation margin) and the aggregate amount of liabilities (gross of variation margin) under derivative contracts for internal linked funds</td>
<td>chapter 8, paragraph 2.20</td>
<td>Instruction 3</td>
</tr>
<tr>
<td>4403</td>
<td>Details of liability to repay variation margin</td>
<td>chapter 8, paragraph 2.20</td>
<td>Instruction 4</td>
</tr>
<tr>
<td>4404</td>
<td>If the surplus units exceed 1% of the net unit liability, a statement of the purpose of the surplus units</td>
<td>chapter 8, paragraph 2.19</td>
<td>Instruction 6</td>
</tr>
<tr>
<td>4405</td>
<td>Disclosure of the name of fund, the net asset value and the liquidity ratio for any fund with material negative liquidity</td>
<td>chapter 8, paragraph 2.19</td>
<td>Instruction 7</td>
</tr>
<tr>
<td>4411</td>
<td>Any restatement of comparatives on Form 44 (not solely due to currency retranslation – see 1602).</td>
<td>chapter 2, paragraph 4.13</td>
<td>Appendix 9.3 paragraph 2A</td>
</tr>
<tr>
<td>4501</td>
<td>Any difference between brought forward amounts on Form 45 and the corresponding carried forward amounts in the previous return (not due solely to currency retranslation – see 1602)</td>
<td>chapter 8, paragraph 2.22</td>
<td>Instruction 2</td>
</tr>
<tr>
<td>4502</td>
<td>Particulars of other income (line 14) or other expenditure (line 26) on Form 45</td>
<td>chapter 8, paragraph 2.22</td>
<td>Instruction 3</td>
</tr>
<tr>
<td>4511</td>
<td>Any restatement of comparatives on Forms 45 and 46 respectively (not solely due to currency retranslation – see 1602).</td>
<td>chapter 2, paragraph 4.13</td>
<td>Appendix 9.3 paragraph 2A</td>
</tr>
<tr>
<td>4611</td>
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<tr>
<td>4701</td>
<td>The number of new group schemes, divided by product code, for which the insurer has no record of benefits at member level</td>
<td>chapter 8, paragraph 4.3</td>
<td>Instruction 5</td>
</tr>
<tr>
<td>4702</td>
<td>Details of approximations used to apportion between product codes on Form 47</td>
<td>chapter 8, paragraph 4.4</td>
<td>Instruction 7</td>
</tr>
<tr>
<td>4703</td>
<td>Details of approximations used in determining columns 3 and 5 of Form 47</td>
<td>chapter 8, paragraph 4.3</td>
<td>Instruction 5</td>
</tr>
<tr>
<td>Code</td>
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<td>Booklet reference</td>
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<tr>
<td>4801</td>
<td>Prescribed details of with-profits business falling within paragraph 1(b) of the definition of with-profits fund in the FSA Handbook Glossary which represents more than 10% of the total with-profits mathematical reserves</td>
<td>chapter 8, paragraph 4.15</td>
<td>Instruction 6</td>
</tr>
<tr>
<td>4802</td>
<td>The treatment on Form 48 of the expected income from any asset where the payment of interest is in default and the amount of interest involved</td>
<td>chapter 8, paragraph 4.11</td>
<td>Instruction 9</td>
</tr>
<tr>
<td>4803</td>
<td>An explanation of the assumption made, in completing Form 48, as to the redemption of securities that may be redeemed over a period at the option of the guarantor or the issuer and stating the value of these securities, where these securities represent more than 1% of fixed and variable interest assets (Form 49 line 61).</td>
<td>chapter 8, paragraph 4.13</td>
<td>Instruction 10</td>
</tr>
<tr>
<td>4804</td>
<td>The yield in column 4 for a type of asset included at line 18 or 28 of Form 48 which is significantly different from the weighted average of the yields for each asset of that type determined in accordance with INSPRU 3.1.34R(2)</td>
<td>chapter 8, paragraph 4.15</td>
<td>Instruction 11</td>
</tr>
<tr>
<td>4805</td>
<td>The aggregate value of assets included at Form 13 line 87 arising from excess exposure to a counterparty or excess concentration with a number of counterparties together with the expected income from those assets</td>
<td>chapter 8, paragraph 4.15</td>
<td>Instruction 12</td>
</tr>
<tr>
<td>4806</td>
<td>Which assets have been used to calculate the investment returns shown at Form 48 lines 21 to 29 column 5</td>
<td>chapter 8, paragraph 4.15</td>
<td>Instruction 15</td>
</tr>
<tr>
<td>4901</td>
<td>The rating agency used to provide the split by credit rating on Form 49</td>
<td>chapter 8, paragraph 4.16</td>
<td>Instruction 6</td>
</tr>
<tr>
<td>5011</td>
<td>Any restatement of comparatives on Form 50 (not solely due to currency retranslation – see 1602).</td>
<td>chapter 2, paragraph 4.13</td>
<td>Appendix 9.3 paragraph 2A</td>
</tr>
<tr>
<td>5101</td>
<td>The number of group schemes for which the insurer has no record of benefits at member level, analysed by product code.</td>
<td>chapter 8, paragraph 4.20</td>
<td>Instruction 6</td>
</tr>
<tr>
<td>5201</td>
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<tr>
<td>5102</td>
<td>Approximations made in estimating the number of policyholders from the number of contracts</td>
<td>chapter 8, paragraph 4.20</td>
<td>Instruction 6</td>
</tr>
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<td>5202</td>
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<td>5402</td>
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<td></td>
</tr>
<tr>
<td>Code</td>
<td>Description</td>
<td>Booklet reference</td>
<td>IPRU(INS) reference</td>
</tr>
<tr>
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</tr>
<tr>
<td>5103</td>
<td>Business for a product classified under the miscellaneous product code if the threshold in Instruction 11 is exceeded</td>
<td>chapter 8, paragraph 4.20</td>
<td>Instruction 12</td>
</tr>
<tr>
<td>5203</td>
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<td>5303</td>
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<td>5403</td>
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<tr>
<td>5104</td>
<td>Approximations used to apportion between product codes</td>
<td>chapter 8, paragraph 4.20</td>
<td>Instruction 13</td>
</tr>
<tr>
<td>5204</td>
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<td>5404</td>
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</tr>
<tr>
<td>5601</td>
<td>The rating agency used to provide the split by credit rating on Form 56</td>
<td>chapter 8, paragraph 2.26</td>
<td>Instruction 3</td>
</tr>
<tr>
<td>5701</td>
<td>Any use of negative mathematical reserves on one group of products to offset positive mathematical reserves on another group of products, giving details of the amounts and products involved</td>
<td>chapter 8, paragraph 4.22</td>
<td>Instruction 9</td>
</tr>
<tr>
<td>5801</td>
<td>Any special provision made for the cost of bonuses payable on future claims</td>
<td>chapter 8, paragraph 4.24</td>
<td>Instruction 3</td>
</tr>
<tr>
<td>5802</td>
<td>Separate identification of each transfer, where Form 58 line 14 or 33 represents more than one transaction</td>
<td>chapter 8, paragraph 4.25</td>
<td>Instruction 7</td>
</tr>
<tr>
<td>5811</td>
<td>Any restatement of comparatives on Form 58 (not solely due to currency retranslation – see 1602).</td>
<td>chapter 2, paragraph 4.13</td>
<td>Appendix 9.3 paragraph 2A</td>
</tr>
<tr>
<td>6001</td>
<td>Where Forms 11 and 12 have not been completed with respect to long term insurance business due to the operation of de minimis limits, the method of estimating the figure at Form 60 line 21 column 5, together with a statement of the gross annual office premiums in force at the valuation date for the total long-term insurance business which is Class IV business, life protection reinsurance business written by a pure reinsurer or a mixed insurer and supplementary accident and sickness insurance.</td>
<td>chapter 3, paragraph 4.7</td>
<td>Instruction 3; also Instruction 2 to Forms 11 and 12</td>
</tr>
<tr>
<td>6011</td>
<td>Any restatement of comparatives on Form 60 (not solely due to currency retranslation – see 1602).</td>
<td>chapter 2, paragraph 4.13</td>
<td>Appendix 9.3 paragraph 2A</td>
</tr>
</tbody>
</table>
Appendix C  Auditor’s report on the return

The following is an example of the form of unqualified report that the auditor might give in the case of a United Kingdom composite insurer completing every Form. Parts of the report are not relevant to an insurer carrying on only general or only life insurance business. The additional references which would need to be included in the case of an insurer with a waiver are also shown. Waivers would also need to be referred to in supplementary note 0101 or 0201 as appropriate. The wording of the note disclosure is usually prescribed in the waiver itself.

Independent auditor’s report to the directors pursuant to rule 9.35 of the Interim Prudential Sourcebook for Insurers

Example Insurance Company Limited

Global business/UK branch business

Financial year ended 31 December 2013

We have audited the following documents prepared by the insurer pursuant to the Accounts and Statements Rules set out in Part I and Part IV of Chapter 9 to IPRU(INS) the Interim Prudential Sourcebook for Insurers, GENPRU the General Prudential Sourcebook and INSPRU the Prudential Sourcebook for Insurers (“the Rules”) made by the Prudential Regulation Authority under section 137G of the Financial Services and Markets Act 2000:

- Forms 1 to 3, 11 to 32, 34 to 45, 48, 49, 56, 58 and 60 (including the supplementary notes) (“the Forms”);
- the statements required by IPRU(INS) rules 9.25, 9.26, 9.27 and 9.29 (“the statements”); and
- the valuation report[s] required by IPRU(INS) rule 9.31((a)) (“the valuation report[s]”).

We are not required to audit and do not express an opinion on:

- Forms 46, 47, 50 to 55, 57, 59A and 59B (including the supplementary notes);
- the statements required by IPRU(INS) rules 9.30, 9.32, 9.32A and 9.36; and
- the certificate required by IPRU(INS) rule 9.34(1).

This report is made solely to the insurer’s directors, in accordance with IPRU(INS) rule 9.35. Our audit work has been undertaken so that we might state to the insurer’s directors those matters we are required by the Rules to state to them in an auditor’s report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the insurer for our audit work, for this report, or for the opinions we have formed.

174 The report on a branch return will need to refer to Form 10 instead of Form 3
175 The Forms referred to should be specific (e.g. 20A, 20 to 32, 34 and 37 to 39, not 20A to 39)
176 A composite which is a ‘realistic basis life firm will prepare a realistic valuation report under rule 9.31(b) / Appendix 9.4A in addition to the valuation report under rule 9.31(a) / Appendix 4. The auditors’ report for such a firm will need to refer to “the valuation reports” and to include the references to INSPRU 1.3 which also appear in square brackets. If there is no realistic valuation report, we will refer to “the valuation report” and to rule 9.31(a) rather than rule 9.31.
Respective responsibilities of the insurer and its auditor

The insurer is responsible for the preparation of an annual return (including the Forms, the statements and the valuation report[s]) under the provisions of the Rules. [The requirements of the Rules have been modified by the direction[s] on [date] made by the Prudential Regulation Authority under section 138A of the Financial Services and Markets Act 2000 and referred to in supplementary note 0101/0201]177. Under IPRU(INS) rule 9.11 the Forms, the statements and the valuation report[s] are required to be prepared in the manner specified by the Rules and to state fairly the information provided on the basis required by the Rules. The methods and assumptions determined by the insurer and used to perform the actuarial investigation as set out in the valuation report[s] are required to reflect appropriately the requirements of INSINU 1.2 [and 1.3].

It is our responsibility to form an independent opinion as to whether the Forms, the statements and the valuation report[s] meet these requirements, and to report our opinion to you. We also report to you if, in our opinion:

- adequate accounting records have not been kept, or returns adequate for our audit have not been received from branches not visited by us; or
- the Forms, the statements and the valuation report[s] are not in agreement with the accounting records and returns; or
- we have not received all the information we require for our audit.

Basis of opinion

We conducted our work in accordance with Practice Note 20, ‘The audit of insurers in the United Kingdom (revised)’ issued by the Auditing Practices Board. Our work included examination, on a test basis, of evidence relevant to the amounts and disclosures in the Forms, the statements and the valuation report[s]. The evidence included that previously obtained by us relating to the audit of the financial statements of the insurer for the financial year on which we reported on [x]178. It also included an assessment of the significant estimates and judgments made by the insurer in the preparation of the Forms, the statements and the valuation report[s].

We planned and performed our work so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the Forms, the statements and the valuation report[s] are free from material misstatement, whether caused by fraud or other irregularity or error, and comply with rule 9.11.

In accordance with IPRU(INS) rule 9.35(1A), to the extent that any document, Form, statement, analysis or report to be examined under IPRU(INS) rule 9.35(1) contains amounts or information abstracted from the actuarial investigation performed pursuant to IPRU(INS) rule 9.4, we have obtained and paid due regard to advice from a suitably qualified actuary who is independent of the insurer.

177 If an insurer has a direction given by the PRA under section 138A of FSMA (or previously by the FSA under section 148) waiving or modifying the form of the return or the GENPRU or INSINU rules under which it has been prepared, two references to the direction will be necessary the report, in the respective responsibilities section and in part(a) of the opinion section. These are shown in square brackets. Under the statutory instruments governing the transition to the PRA regime, a waiver given by the FSA that is still in date is now treated as ‘made by’ the PRA under section 138A and wording of the auditor’s report should reflect this.

178 The sentence in the basis of opinion section referring to the audit of the financial statements is normally appropriate. If, however financial statements have not been prepared and audited, it should be omitted. Further details of the work undertaken may be added. If the audit has been undertaken, but the financial statements have not yet been signed, the words ‘on which we reported on [x]’ should be removed.
Opinion

In our opinion:

(a) the Forms, the statements and the valuation report[s] fairly state the information provided on the basis required by the Rules [as modified] and have been properly prepared in accordance with the provisions of those Rules; and

(b) the methods and assumptions determined by the insurer and used to perform the actuarial investigation as set out in the valuation report[s] appropriately reflect the requirements of INSPRU 1.2 [and 1.3].

Ernst & Young LLP
Statutory Auditor
Town
Date
Appendix D  Auditor’s statement on the group capital adequacy report

The following is an example of the form of an unqualified statement that the auditor might give on the report prepared under Part V of Chapter 9. It will need to be tailored to meet individual circumstances (e.g. where a waiver has been issued or where the group capital adequacy report does not include a statement of its basis of preparation). In particular, a disclaimer will be required if additional information required by rule 9.40(1A) (which is not subject to the auditor’s review) is included as part of a single submission including the rule 9.40(1) information.

Independent auditor’s statement to the directors pursuant to rule 9.40(3)(c) of the Interim Prudential Sourcebook for Insurers (“IPRU(INS)"

Example Insurance plc

Financial year ended 31 December 2013

We have reviewed the report prepared pursuant to rule 9.40(1) of IPRU(INS) on pages x to x (“the report”) by Example Insurance plc (“the insurer”).

This statement is made solely to the insurer’s directors in accordance with rule 9.40(3)(c).

Our review has been undertaken so that we might state to the insurer’s directors those matters we are required to state to them in an auditor’s statement and for no other purpose.

To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the insurer for our review, for this statement, or for the opinion we have formed.

Respective responsibilities of the insurer and its auditors

The insurer is responsible for the preparation of the report under the provisions of rule 9.40(1) of IPRU(INS). [The requirements of the Rules have been modified by the direction[s] on [date] made by the Prudential Regulation Authority under section 138A of the Financial Services and Markets Act 2000 and referred to in [note ( ) to or paragraph ( ) of] the report]. [The report has been prepared on the basis set out on page x.]

It is our responsibility to carry out the procedures set out below, in the basis of opinion section, and to state whether anything of significance has come to our attention to indicate that the report has not been properly compiled in accordance with INSPRU 6.1 and rule 9.40(1) of IPRU(INS) from information provided to the insurer by other members of the insurance group and from the insurer’s own records.

Our work did not constitute an audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board of the information provided to the insurer by other members of the insurance group and included no independent examination by us of any of the underlying financial information therein. It therefore provides a lower level of assurance than an audit.

Basis of opinion

Our work consisted principally of:

179 If the insurer prepares a single report which combines both the rule 9.40(1) information on which the auditor is required to report and the 9.40(1A) reconciliations which fall outside the scope of auditor review, the extent of the auditor’s responsibility needs to be made clear.

180 If the FSA or PRA has issued a waiver modifying the relevant rules this should be referred to within respective responsibilities (as shown in square brackets) and the opinion section of the auditor’s statement (by inserting the words ‘as modified’ after the appropriate reference, depending on which rule is modified). Under the statutory instruments governing the transition to the PRA regime, a waiver given by the FSA that is still in date is now treated as ‘made by’ the PRA under section 138A and wording of the auditor’s report should reflect this.

181 If the insurer does not include in the report a statement on the basis of preparation , this paragraph (and the reference to a basis of preparation included in the basis of opinion) should be omitted. Similar considerations apply to the reference to instructions provided to other group companies.
• comparing, on a test basis, the compilation of the report with the information provided to the insurer by other members of the insurance group and with information from the insurer’s own records;

• confirming the mathematical accuracy of the compilation of the financial information contained in the report;

• reading the instructions issued to other members of the insurance group and comparing these with the requirements set out in INSPRU 6.1; and

• comparing, on a test basis, the information provided to the insurer by other members of the insurance group and any adjustments made by the insurer thereto, with:

  [(a) the instructions issued by the insurer;

  (b) the basis of preparation set out on page [x]; and

  (c)] the requirements set out in INSPRU 6.1

to identify any significant areas where such information may not comply [therewith][with (a), (b) and (c) above].

Opinion

On the basis of the above procedures, nothing of significance has come to our attention to indicate that the report has not been properly compiled in accordance with INSPRU 6.1 and rule 9.40(1) of IPRU(INS) from information provided to the insurer by other members of the insurance group and from the insurer’s own records.

Ernst & Young LLP
Statutory Auditor
Town
Date
Appendix E  UK-deposit insurers and EEA-deposit insurers

Chapter 2 introduced the concept of UK-deposit insurers and EEA-deposit insurers, which arise because of the requirement of the EU direct insurance Directives for EEA States to enact legislation enabling the main supervision of a non-EEA direct insurer carrying on business in more than one EEA State to take place in one of the States concerned. Such an insurer is referred to as a UK-deposit insurer where the insurer has made the necessary deposit and is supervised as to its EEA activities primarily in the UK, and as an EEA-deposit insurer where the deposit has been made in another EEA State and that State’s competent authority has the supervisory responsibility. There was no subsequent discussion of such insurers in the body of this booklet in view of their rarity. The present appendix has been prepared to provide a brief summary of the considerations that would relate to the returns of such insurers.

UK-deposit insurers

By comparison with an external direct insurer, a UK deposit insurer is similarly required to prepare a global return, but instead of submitting an additional UK branch return showing compliance with UK branch MCR requirements it will make an EEA branch return, which will demonstrate the calculation and coverage of an EEA MCR. The principal differences between such a return and a UK branch return are as follows:

► The figures included will relate to all branches carrying on business within the EEA States concerned.

► The narrative heading will indicate “EEA branch business” rather than “UK branch business” and the computer heading will include “CM” rather than “UK”.

► A category 5 (other than long-term insurance) or category 9 (long-term insurance) Form 13 must be prepared to identify assets maintained in the United Kingdom and the other EEA States where business is carried on (instead of the category 3 or 7 Form 13).

It would clearly be logical for the return to identify, by way of supplementary note, the EEA States concerned.

In terms of INSPRU 1.1, the capital requirements (INSPRU 1.1.43G to 1.1.91R) apply to the global activities, while the sections relating to establishing technical provisions (INSPRU 1.1.12R to 1.1.19G), assets of a sufficient value to cover technical provisions (INSPRU 1.1.20R to 1.1.29G), matching of assets and liabilities (INSPRU 1.1.34R to 1.1.42G) and premiums for new business, apply in respect of the activities of the firm carried on from branches in EEA States. The localisation rules of INSPRU 1.1.30R to 1.1.33R do not apply. The specific branch requirements including the requirement to calculate and cover an EEA MCR are set out in INSPRU 1.5.

In addition to the UK requirements, such an insurer will need to submit whatever branch information is required by the competent authorities in each of the other EEA States concerned (in effect this is the information required in that State equivalent to the information that an EEA-deposit insurer would need to submit to the PRA).

EEA-deposit insurers

Such an insurer is in many ways similar to a Swiss general insurer, save that the relatively generous treatment accorded extends to the long-term insurance business as well as to the general insurance business. It is therefore exempt from the requirement to submit a global return and will prepare a UK branch return which will omit Forms 1, 2, 3, 11, 12, 18, 19 and 60 (the responsible competent authority will receive more complete information, analogous to that described above for a UK-deposit insurer).
In terms of INSINU 1.1, the sections relating to establishing technical provisions (INSINU 1.1.12R to 1.1.19G), assets of a sufficient value to cover technical provisions (INSINU 1.1.20R to 1.1.29G), matching of assets and liabilities (INSINU 1.1.34R to 1.1.42G) and premiums for new business, apply in respect of the activities of the firm carried on from a branch in the UK. The capital requirements (INSINU 1.1.43G to 1.1.91R) and the localisation rules of INSINU 1.1.30R to 1.1.33R do not apply. One effect of these exemptions is that such a firm does not have to submit Form ECR1 (which would otherwise apply to its global business) as it is not subject to INSINU 1.1.72BR.

An EEA-deposit insurer does not have to maintain a deposit in the UK.
Appendix F  Marine Mutuals

1. Under IPRU(INS), specialist marine mutuals such as protection and indemnity clubs have the option to submit a special set of Forms (M1 to M5) if they find the standard reporting Forms were regarded as unsuitable. The modified format will not necessarily suitable for all marine mutuals and some might prefer to follow standard reporting or apply for a waiver to allow for a bespoke format.

2. “Marine mutual” is defined by Chapter 11 as an insurer:
   (a) whose insurance business is restricted to the insurance of its members or their associates against loss, damage or liability arising out of marine adventures (including losses on inland waters or any risk incidental to any sea voyage); and
   (b) whose articles of association, rules or bye laws provide for the calling of additional contributions from, or the reduction in benefits to, the majority of its members, in either case without limit, in order to ensure that the insurer has sufficient financial resources to meet any valid claims as they fall due.

   If a marine mutual were to change its articles to remove the right to supplementary calls it would therefore be obliged to complete a full return.

3. If a marine mutual chooses to avail itself of the modified format, rule 9.36A exempts it from rules 9.3 to 9.4, 9.12 to 9.28, 9.31, 9.32 and 9.34 to 9.36. The gaps in this list of rules mean that it still has to include in its return a rule 9.29 statement of additional information on derivative contracts, a rule 9.30 statement of additional information on controllers and a rule 9.32A statement of additional information on financial reinsurance and other financing arrangements. It is also still subject to the normal signature requirements of rule 9.33. Rule 9.6(1) specifically allows a marine mutual filing a return in the modified format a deadline of 3 months even if the return is not submitted electronically.

4. In addition to the rule 9.29, 9.30 and 9.32A statements, a return in the modified format will comprise:
   (a) Forms 1, 3, 11 and 12
   (b) Forms M1 to M5 as set out in Appendix 9.8, together with certain supplementary notes
   (c) the documents required to be annexed by rule 9.36B, comprising:
      (i) a description of the significant reinsurance arrangements which will be in operation in the following financial year (arguably of more relevance than the historical information provided under rule 9.32 in a standard return)
      (ii) information about contracts where the available reinstatements are likely to be exhausted or where reinsurers have ceased to pay claims in full, similar to the equivalent Appendix 9.5 disclosures in a standard return
      (iii) a statement concerning the default rates of members (or adjusted default rates, as the case may be) on the supplementary calls collectable during the financial year and the two previous financial years, and the total
amount of each such call, the financial year to which it relates, the amount paid and the amount remaining outstanding.

(iv) a copy of the rules of association of the marine mutual in force at the date of the deposit of the return, unless there has been no change in a copy of the rules deposited with the return for a previous financial year.

(d) a directors’ certificate in the format of Part II of Appendix 9.8 (rule 9.36D).

5. The Forms set out in Appendix 9.8 can be completed in units of £, £000, US$ or US$000 as appropriate. In completing these Forms the marine mutual must disregard reinsurance arrangements with any relevant company and must treat income and expenditure and assets and liabilities of any relevant company as, respectively, income and expenditure and assets and liabilities of the marine mutual. “Relevant company” is defined by Chapter 11 as an insurer whose insurance business is restricted to reinsurance of the marine mutual on terms which provide that the marine mutual can cancel the reinsurance arrangements at any time and can require the insurer immediately to transfer its assets and liabilities to the marine mutual.

6. Form M1 represents a one page revenue account, with a mixture of gross and net figures. Other income (line 17) and other expenditure (line 33) are required to be explained in supplementary notes.

7. Form M2 presents a statement of assets and liabilities. The assets shown represent the aggregate of admissible assets per Form M3 (line 11) and calls approved by the Board but unmade at the year end (line 12); if a call had been made prior to the year end it would have given rise to a premium debtor on Form M3 to the extent that it was unpaid. Liabilities are broken down into five headings in view of the lack of any Form 15 equivalent. The figures reported at lines 21 and 22 for what are effectively gross technical provisions must agree to prescribed sources on other Forms, while any “other” liabilities at line 25 must be explained in a supplementary note.

8. Form M3 provides the same analysis of admissible assets as Form 13. However, there are not so many Instructions to Form M3. As a result of the Instructions and the Form itself, it is necessary to provide the equivalent of supplementary notes 1301, 1302, 1303 and 1315 where these are applicable. The rules relating to the valuation of assets are fully applicable to a marine mutual.

9. Form M4 provides an analysis of calls, premiums and claims for each policy year in respect of the present financial year. The 15 most recent policy years are shown individually, with any movement on earlier policy years being reported in aggregate at line 26. The Form fulfils some of the functions of Form 24 and Form 25, and like those Forms does not show any cumulative information for a policy year. However, policy years are shown as rows (more like Form 23) rather than as columns, and there are no overall balances reported, so the Form is in effect providing a sub-analysis of figures reported on Form M1. Separate Forms are required for each class of insurance business, with classes being defined for this purpose as:

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182 The concept of consolidating figures for a relevant company only appears in IPRU(INS), and has no equivalent in GENPRU and INSPRU. The capital resources and requirement reported in the PRA return are not, as a result of the way in which the rules are structured, the same as the figures calculated on a standalone basis under GENPRU and INSPRU.

183 This Form at one time represented a statement of solvency, but Forms 1 and 3 now have to be prepared and assume some of the previous functions of the Form.
01 Protection and Indemnity
02 Hull and machinery
03 Freight Demurrage and Defence
04 War risks
05 Strikes
06 Other

If a class 06 Form is completed, a supplementary note is needed to explain the nature of the “other” business.

10. Form M5 is in effect the same as an earlier version of Form 17 as it applied at one time to an insurer. As there is no Form 15 equivalent for a marine mutual, any provision for reasonably foreseeable adverse variations will need to be reported at line 25 of Form M2.

11. Forms 1, 3, 11 and 12 need to be completed in the same units as those used in Form M1. If these units are US$ or US$000, the references to the sterling equivalent of Euro in line 33 of Forms 11 and 12 are to be taken to be references to the US$ equivalent of the specified number of Euro, and the Forms must be amended to reflect the use of US$. Instruction 4 to Forms 11 and 12 requires a supplementary note to Form 11 (code 1101) to be provided in these circumstances to state the bases of conversion adopted. The inclusion of supplementary calls on Form 3 is only possible if a waiver has been obtained.

12. The directors’ certificate for a marine mutual is prescribed by paragraph 2 of Appendix 9.8: the normal provisions about statements that cannot truthfully be made are applied by paragraph 4. Paragraph 2 is equivalent to the standard directors’ certificate considered in chapter 9, and calls for four statements and some additional information. Of the four required statements, (i) and (ii) correspond to the Appendix 9.6 requirements for a general insurer. The other two statements are marine mutual specific and will indicate that each member of the marine mutual which is subject to those parts of the mutual’s rules obliging members to pay their share of supplementary calls for the year and of calls to meet the minimum capital requirement (including any sum needed to make good failure by other members to pay calls made upon them) has accepted those rules, and that the marine mutual is empowered to make supplementary calls on its members which, if met, would produce sufficient assets to meet the minimum capital requirement.

13. The additional information required by paragraph 2 relates to:

(a) the number of members of the marine mutual who are not reinsured members;

(b) the number of fixed premium members (on whom supplementary calls may not be made);

(c) the number of reinsured members (that is, members whose contract of insurance with the marine mutual is a contract of reinsurance); and

(d) the tonnage of shipping attributable to each of the above classes of members, taken separately, and covered by the marine mutual at the end of the financial year.
14. Normal audit requirements apply to the Forms, supplementary notes and rule 9.29 statement. The certificate and the rule 9.30, 9.32A and rule 9.36B statements are outside the scope of the audit.

15. From the date when the return is deposited with the PRA until the date when the next return is submitted, a marine mutual taking advantage of rule 9.36A to submit a modified return is required, by virtue of rule 9.36C, to provide the PRA with written notice of:

(a) any change which is proposed in the rules of association of the marine mutual, not less than 14 days before the change is put to a meeting;

(b) any change which has been made in the rules of association within seven days of the change

(c) any significant change to the reinsurance arrangements within seven days of the change

(d) a fall in tonnage entered by its members of 10% net or more since the end of the financial year, within seven days of the marine mutual becoming aware of this

(e) whether tonnage entered by its members who have withdrawn from membership or who have defaulted on their obligations has increased so as to exceed 10% of total tonnage entered, whether before, on or after the date of deposit of the return, within seven days of the date of deposit or of the marine mutual becoming aware of this, whichever is earlier.

16. The notifications in the foregoing paragraph are arguably the types of development that would anyway require notification to the PRA under Principle 11. Where a change of rules is proposed that would be notifiable under (a), it would seem desirable, where possible, to give the PRA more than the minimum 14 days’ notice.
Appendix G  Friendly Societies

1. Friendly societies represent a type of mutual organisation which had its origins in Roman times. The friendly societies movement probably had its heyday in the 1800s, when following an Act of 1875 to require the registration and auditing of friendly societies there were as many as 27,000 registered societies. The number of friendly societies currently registered is far smaller. While some of these are locally or affinity based, others are analogous to large insurance companies.

2. Regulation of friendly societies which effect or carry out contracts of insurance was taken over by the PRA and FCA at legal cutover. Specific prudential standards for friendly societies are set out in IPRU(FSOC), which unsurprisingly bears a close family resemblance in many respects to IPRU(INS).

3. IPRU(FSOC) underwent less pruning than IPRU(INS) at the time of the implementation of PRU, and seven of the original eight chapters survive. The current structure of the Sourcebook is as follows.
   - Chapter 1 – Application
   - Chapter 2 – Integrity, skill, care and diligence
   - Chapter 3 – Management and control
   - Chapter 4 – Financial prudence
   - Chapter 5 – Prudential reporting
   - Chapter 7 – Definitions
   - Chapter 8 – Transitional provisions

4. For reporting purposes, friendly societies are divided into directive friendly societies and non-directive friendly societies. The latter is the key defined term in the Glossary. A friendly society is regarded as a non-directive friendly society if it is any of the following:

   (a) A friendly society whose insurance business is restricted to the provision of benefits which vary according to the resources available and in which the contributions of the members are determined on a flat-rate basis;

   (b) A friendly society whose long-term insurance business is restricted to the provision of benefits for employed and self-employed persons belonging to an undertaking or group of undertakings, or a trade or group of trades, in the event of death or survival or of discontinuance or curtailment of activity (whether or not the commitments arising from such operations are fully covered at all times by mathematical reserves);

   (c) A friendly society which undertakes to provide benefits solely in the event of death where the amount of such benefits does not exceed the average funeral costs for a single death or where the benefits are provided in kind;

   (d) A friendly society (carrying on long-term insurance business):

      (i). whose registered rules contain provisions for calling up additional contributions from members or reducing their benefits or claiming assistance from other persons who have undertaken to provide it; and
(ii). whose annual gross premium income (other than from contracts of reinsurance) has not exceeded €5 million for each of the three preceding financial years;

(e) A friendly society (carrying on general insurance business):

(i). whose registered rules contain provisions for calling up additional contributions from members or reducing their benefits;

(ii). whose gross premiums income (other than from contracts of reinsurance) for the preceding financial year did not exceed €5 million; and

(iii). whose members provided at least half of that gross premium income; or

(f) A friendly society whose liabilities in respect of general insurance contracts are fully reinsured with or guaranteed by other mutuals (including friendly societies), where the mutuals providing the reinsurance or the guarantee are subject to the rules of the First Non-Life Directive.

In each case the insurance business must be limited to that described.

5. A non-directive friendly society is subject to the whole of IPRU(FSOC). A directive friendly society is only subject to Chapters 1, 2 and 3 (with the exception of rule 3.1(7)), rule 4.20, rule 5.1A and Chapters 7 and 8. The principal effect of the distinction is that whereas a non-directive friendly society has to comply with the special reporting requirements of Chapter 5 of IPRU(FSOC), which will be described in the remainder of this chapter, a directive friendly society has to comply with rules 9.1 to 9.36, 9.37 and 9.39 of IPRU(INS). The annual return for a directive friendly society will therefore be prepared under the same rules as those applying to an insurance company which have been covered in the body of this booklet. The one subtlety is that the references on Forms 13, 14 and 15 to the insurance accounts rules are to be taken as referring to the Friendly Societies (Accounts and Related Provisions) Regulations 1994 (rule 5.1A(2)).

6. A non-directive friendly society is outside the scope of the requirements of SUP 4.3 to appoint actuaries to perform the actuarial function and with-profits actuary function. However, SUP 4.4 requires such a society to appoint an “appropriate actuary” to carry out the triennial investigation and prepare an abstract of this report for the purposes of the FSC2 and FSC3 returns and to provide the interim certificate representing FSC4 (or make a statement that he is unable to give such a certificate).

7. For a non-directive friendly society, the following types of regulatory return are prescribed:

► FSC1 – this is required annually of an incorporated non-directive friendly society.

► FSC2 – this is required at least every three years of all unincorporated non-directive friendly societies.

► FSC3 – this is required at least every three years of an incorporated non-directive friendly society which is carrying on general insurance business.

► FSC4 – this is a certificate to be given annually by the appropriate actuary in the absence of a return for that year to the effect that there has been no material change in the financial condition of the friendly society since the last abstract was submitted.
8. There is a close family resemblance between the reporting forms for friendly societies and the reporting forms for insurers, although in some cases the IPRU(FSOC) forms correspond to older reporting requirements for insurers (e.g. the use of Form 9). The following coverage of the returns will do no more than summarise the elements of each return and highlighting some key differences from the IPRU(INS) requirements covered in the main body of this booklet.

9. The FSC1 return comprises:

(a) Form FSC1, which provides a front sheet and a contents section indicating the number completed of each Form and whether a summary form has been used;

(b) a balance sheet consisting of Forms 9, 13, 14, 15 and 17 (as appropriate), prepared in accordance with the requirements in Appendix 6;

(c) revenue accounts consisting of Forms 40, 40A, 40B and 40C (as appropriate) and 41 to 45 prepared in accordance with the requirements in Appendix 8;

(d) a valuation abstract consisting of Forms 46 to 49, 51 to 58, 60, 11, 12 and 61A (as appropriate) prepared in accordance with the requirements in Appendix 9;

(e) a certificate in the terms of Form 61B;

(f) a statement confirming that the friendly society consents to the FSC1 return being placed on its public file; and

(g) an auditor’s report in Form 61C.

10. The FSC1 Forms have a slightly different look to their IPRU(INS) counterparts, as individual cells are framed by boxes instead of appearing as part as a grid, but in substance are much the same as the current Forms. Points of difference worth noting are:

► Form 9 follows line by line the former Form 9 (that insurance companies had to complete prior to 2005). It uses (as does IPRU(FSOC) as a whole) the ‘old’ terminology of required minimum margin rather than capital resources requirement.

► Form 13 retains a simpler form of reconciliation that applied to insurers prior to 2005.

► Form 14 has separate lines for the balance on the Management Fund, Members’ surplus and savings accounts and other Revenue Account funds.

► Form 17 remains an earlier version of that currently in IPRU(INS), including comparative figures.

► In addition to the basic Form 40 providing a revenue account for long-term insurance business, there is a Form 40A for other revenue account funds, 40B for the Management fund and 40C for Member surplus and savings accounts, all with a tailored design to suit the circumstances of these funds.

11. The FSC2 return comprises:

(a) Form FSC2;

(b) Form 9, which is equivalent to Form 9 in the FSC1 return;

(c) Form 9A, which is a descriptive section, with the Form providing a front sheet to a synopsis of the report by the appropriate actuary;
(d) Form 9B, which is the actuary's certificate;

(e) Form 9C which contains signatures; and

(f) a statement confirming that the friendly society consents to the FSC2 return being placed on its public file.

12. The FSC3 return comprises

(a) Form FSC3;

(b) a balance sheet consisting of Forms 9, 11, 12, 13, 14, 15 and 17 (as appropriate), prepared in accordance with the requirements in Appendix 6;

(c) revenue accounts consisting of Forms 20, 21, 22 and 23 prepared in accordance with the requirements in Appendix 7;

(d) Form 23A, which is a descriptive section, with the Form providing a front sheet to a synopsis of the report by the appropriate actuary;

(e) a certificate by the appropriate actuary in the terms of Form 23B;

(f) a report of the auditor in Form 23C;

(g) Form 23D, which contains signatures; and

(h) a statement confirming that the friendly society consents to the FSC3 return being placed on its public file.

13. Matters of interest on the FSC3 documents are:

► Only accident year accounting is provided for, which reduces the number of lines required on Forms 11, 12 and 20.

► The Regulator’s policy has been to apply indexation of the Euro break points for the solvency requirement calculation to friendly societies

► Forms 20 to 23 are prepared for each class of business, with an additional summary Form only required for Form 20. The relevant classes of business are defined by Part III of Chapter 7 of IPRU(FSOC) as the three general insurance business authorisation classes that are relevant to friendly societies: 1 Accident, 2 Sickness and 16 Miscellaneous financial loss. Given the small number of classes, no equivalent to Form 20A is required.

14. FSC1, FSC2 and FSC3 need to be signed by the chief executive, the secretary and one committee member of the friendly society (or two members of the committee if the offices of chief executive and secretary are held by the same person). The deadline for submissions of all the returns remains at the 6 months enjoyed at one time by insurance companies. With effect from the end of 2013, a single, signed paper copy of FSC1, FSC2 and FSC3 is required (down from three in previous years): there is no provision in IPRU(FSOC) for electronic submission. The address for lodgement is the generic Bank of England address referred to at section 5 of chapter 2 of this booklet.
Appendix H  Solvency II

1. A number of references have been made earlier in this booklet to Solvency II, which involves a fundamental review of the capital adequacy regime for the European insurance industry. While this is not of specific relevance to the 2013 returns, it is a subject that is taking up much of the time of the PRA and insurers alike. As noted below, the implementation date for Solvency II has been confirmed as 1 January 2016. Returns under the current regime will still be required for 2014 and 2015 year ends, notwithstanding the implementation of the EIOPA Solvency II interim measures which, as outlined below, will require reporting for the year ended 31 December 2014.

2. This appendix is included to provide a brief overview of some key concepts and the current state of play. This is particularly appropriate as Solvency II has a direct bearing on future regulatory reporting, not just as a result of the need for this to reflect the new prudential rules, but because one of the elements of the measures supporting the Directive will be the introduction of standardised reporting formats which will apply across Europe, with the quantitative reporting templates replacing the current PRA Forms.

3. The Solvency II regime will be introduced in EU member states by implementation of the Solvency II Directive into the laws of the EU member states. Once implemented in the UK the Solvency II Directive, in much the same way as FSMA, will provide a framework, with the detailed rules appearing elsewhere.

4. The different layers of rules and guidance that make up the regime are:

   ► The Solvency II Directive, a ‘Framework’ Directive, containing principles and high-level rules, and containing provision for implementing powers for ‘level 2’ measures to be made on a delegated basis.

   ► Delegated Acts - prepared in consultation with the European Insurance and Occupational Pensions Authority (EIOPA) and approved and issued by the European Commission. They are legally binding and aim to ensure the uniform application of the Solvency II Directive.

   ► Implementing technical standards – drafted by EIOPA and adopted by the Commission. They are legally binding and aim to ensure the uniform application of the Solvency II Directive.

   ► Guidance developed by EIOPA. The purpose of this is to ensure consistent implementation of the Solvency II requirements.

   ► Enforcement of all EU measures, led by the Commission.

5. The Solvency II Directive was adopted by the European Parliament in 2009, and was originally scheduled for implementation in 2012. It has since been amended by FICOD1, and its transposition and implementation dates have now been formally amended twice, most recently by the Solvency II (Amendment) Directive of 11 December 2013 (Directive 2013/58/EU). This Directive set the deadline for transposition at 31 March 2015 the implementation date at 1 January 2016. Before it comes into force, the Solvency II Directive will be amended again, by the Omnibus II Directive, the text of which has now been agreed between the Trialogue parties (European Commission, Council and Parliament). The Omnibus II Directive is currently due to be voted upon by the European Parliament in a plenary vote on 11 March 2014.
6. The framework Directive will need to be transposed into UK law (see below), and will impact on both FSMA and the regulations made thereunder and on the PRA Handbook.

7. The development of Solvency II has taken place against the background of the creation in 2011 of three European Regulatory Authorities (“ERAs”). Reference has already been made to EIOPA. The other two are the European Securities and Markets Authority (“ESMA”) and the European Banking Agency (“EBA”). The ERAs are responsible for level 3 measures and for making recommendations as to level 2 measures. These bodies work with the European Systemic Risk Board to ensure financial stability and to strengthen and enhance the EU supervisory framework. The ERAs were created by the first “Omnibus Directive” (Directive 2010/78/EU).

8. Whilst some of the delay in the implementation of Solvency II may be attributable to the exercise of the new powers that the ERAs have, a major sticking point was the inability of key participants in debate to agree on the approach to be adopted for insurance products with long term guarantees. A full description of this debate is outside the scope of this booklet. Agreement was finally reached between the triilogue parties on this issue as part of the agreement of the final text of the Omnibus II Directive on 13 November 2013.

9. Solvency II is based on a “three pillar” approach. The pillars, which are analogous to those that apply to banks under the Basel Accords, are not referred to as such in the Directive, but have been used by EIOPA as a convenient way of grouping the Solvency II requirements.

► Pillar 1 – this contains the basic financial requirements, and aims to ensure that insurers are adequately capitalised with sufficient risk-based capital. It provides for the use of internal models by firms;

► Pillar 2 – this is concerned with imposing higher standards of risk management and governance within a firm’s organisation. This pillar also gives supervisors greater powers to challenge firms on risk management issues. The Own Risk and Solvency Assessment (“ORSA”) requires a firm to undertake its own forward looking assessment of its risk, corresponding capital requirements and adequacy of capital resources;

► Pillar 3 – this aims to achieve greater levels of transparency in the information provided to supervisors and the public.

Reporting – Pillar III

10. On 9 July 2012 EIOPA published a “near final” version of the reporting requirements including ‘near final’ level 3 guidelines on the qualitative disclosures and the quantitative reporting templates, taking account of the feedback from the earlier consultation.¹⁸⁴

11. The key elements of the reporting requirements are as follows:

► The Solvency and Financial Condition Report (SFCR), providing the information to be publicly disclosed.

► Regular Supervisory Reporting (RSR) providing information to the regulatory authorities but not publicly disclosed.

12. The SFCR is intended to be published and submitted electronically to the supervisor within 14 weeks of the end of the financial year, which is marginally longer than the three months currently allowed for the filing of an electronic PRA return. Public disclosure will be achieved through publication on the website, and by sending a copy to any stakeholder who requests one within 5 business days. The structure of the SFCR will be as follows:

- Executive summary.
- Business and performance
- System of governance
- Risk profile
- Regulatory balance sheet – valuation for solvency purposes
- Capital management (including information for undertakings with an approved internal model)
- Quantitative templates

13. The RSR is intended to be a standalone document which will incorporate the information in the SFCR and adopt the same general structure, but with more detail and a “forward-looking” focus. The same 14 week filing deadline will apply. For the first financial year end after the Directive comes into force, all undertakings will be required to complete a full qualitative RSR. Thereafter, unless an undertaking is notified by its supervisor that a full qualitative RSR will have to be completed annually, only material changes will have to be reported, although it will be necessary to report annually all the information within the SFCR. A periodic full qualitative RSR will be required at a frequency set by the supervisor.

14. Quantitative reporting templates will be required annually within the same 14 week deadline that applies to the RSR and the SFCR. Some of the templates will also be required on a quarterly basis within 5 weeks of the end of the quarter. The templates published in July 2012 are grouped so that it is clear what needs to be completed on an annual or quarterly basis for solo firms and groups, and the subset which is to be subject to public disclosure.

UK Implementation of Solvency II

15. Despite the previous uncertainties and slippages in the timetable, the consultation process relating to the UK implementation of Solvency II began in 2011. In November 2011, the Treasury published a consultation document on the changes to the legislation necessary to transpose the Framework Directive. The changes envisaged were relatively brief as much of the implementation could be achieved through the inclusion of rules in the Handbook. The four areas that needed to be addressed by legislation were:

- the amendments necessary to set out the conditions under which undertakings may be authorised and deauthorised to carry on insurance and reinsurance business
- new powers for the PRA, aimed mostly at enabling the PRA to approve the instruments undertakings will use to calculate the solvency position
new duties for the PRA aimed at mandating its participation in the new European supervisory framework
amendments to align UK terms and definitions with those in the Directive.

16. The Treasury consultation was complemented by the FSA's CP 11/22 – Transposition of Solvency II part 1. As the name implies, a two stage consultation process was envisaged, with a second CP to be issued once the Omnibus II Directive and level 2 measures have been finalised.

17. However, in view of the continuing delays to the commencement of the new regime, the FSA issued a second consultation paper, CP 12/13 covering further aspects of the new rules in July 2012. This indicated that there would be more UK consultation as necessary once the “European and UK regulatory landscape are sufficiently settled”.

18. The FSA intended to create a new Handbook module, the Prudential Sourcebook for Solvency II Insurers (SOLPRU) which would apply to insurers within the scope of Solvency II. We however now understand that the PRA approach may now be slightly different to in order to incorporate the rules into the format of the new PRA rulebook. We are expecting a consultation paper in the third quarter of 2014, setting out the proposals.

19. The general approach to transposition of the Directive is referred to in the CPs as “intelligent copy out”; following the words of the Directive as closely as possible, and only departing from this where necessary to provide greater clarity or where the Directive requires the regulator to make a discretionary decision.

20. Not all PRA authorised insurers fall within the scope of the Solvency II Directive, as this contains various exclusions, including exclusions on the grounds of size (gross written premiums do not exceed €5 million, gross technical provisions do not exceed €25 million and various other conditions are satisfied). The options available to the PRA for dealing with such firms appear to comprise the following:

- Continue to apply the current regime, which would mean, inter alia, the survival of the existing regulatory reporting Forms.
- Adopt a super-equivalent approach and apply Solvency II principles despite the fact that the firms concerned are outside the scope of the Directive.
- Develop a compromise approach, adapting Solvency II principles in a proportionate way.

21. CP 11/22 confirmed, unsurprisingly, that the Solvency I provisions will continue to apply to such firms in the short term, although it is open to an insurer outside the scope of Solvency II on the grounds of size to apply for authorisation under Solvency II, which would make the Solvency II rules applicable. The position will be reviewed after the implementation of Solvency II.

22. Paragraph 15.7 of CP 11/22 indicated that in addition to the prescribed harmonised reporting under Solvency II, the regulator would develop certain quantitative reporting templates designed to address aspects of the UK insurance market that are not specifically reflected in the Directive’s reporting requirements. An early version of these templates was released to the ABI and other industry trade bodies in 2012. These covered primarily revenue reporting, additional with profits reporting and reporting by PI clubs. However, as noted in CP12/13, their development has now been integrated within an overall review of reporting and notification requirements under the jurisdiction of the PRA and we now understand that they will be released for consultation towards the end of 2014.
Interim measures

23. Following a consultation process, on 31 October 2013 EIOPA formally issued its final Preparatory Guidelines for National Competent Authorities (NCAs) (National Regulators) to adopt in preparation for full Solvency II implementation on 1 January 2016. NCAs then had two months to inform EIOPA whether they would comply with these guidelines or explain their decision not to comply with particular guidelines.

24. The areas covered were

- System of Governance – extensive implementation of requirements for an effective system of governance which provides for sound and prudent management and an effective risk management system, from 1 January 2014;

- Forward looking assessment of own risks (FLAOR) (similar to the ORSA) – little guidance or prescription is provided for this, but subject to full implementation for all insurers (although other quantitative aspects of the Preparatory Guidelines are subject to thresholds). During 2014 the first FLAOR needs to be submitted to the NCA. In 2015 the second FLAOR is required to be submitted and the NCA will expect clear development and enhancement of the documents between submissions.

- Pillar III reporting requirements – see below.

- Internal Model pre-application – there is limited new material in the Preparatory Guidelines. The areas of focus are validation, independence requirements and the need to stress / scenario tests to cover relevant material risks. A user manual or process documents, including clear referencing and version control, will also be required to enable NCA or third-party understanding of the model.

- Pillar 1 – this is not a Preparatory Guideline in its own right, but capabilities for point-in-time calculations and projections are established by FLAOR and Pillar III guidelines.

25. The PRA gave two industry briefings on 12 December 2013 on Solvency II. These sessions were extensive and covered all pillars as well as the PRA's expectations as to good practice for internal models. The PRA stressed the certainty in the timetable and implementation date of 1 January 2016. The PRA stated that it is now time for firms to reassess priorities and make a concerted effort to be able to demonstrate compliance with the new regime from 1 January 2016.

26. On the same day, the PRA's Supervisory Statement (SS4/13): ‘Solvency II: applying EIOPA’s preparatory guidelines to PRA-authorised firms’ was published and is now available on the PRA website: http://www.bankofengland.co.uk/pra/Pages/solvency2/preparing.aspx . This Supervisory Statement sets out the PRA’s expectations of firms in relation to the Preparatory Guidelines as issued by EIOPA in October 2013. The PRA makes clear in this Supervisory Statement that the emphasis is on preparation for Solvency II and not early implementation. The Statement does not contain any additional requirements over and above those contained in the Preparatory Guidelines themselves.

27. The PRA response to EIOPA on the Pillar III reporting guidelines was that it would comply or it intended to comply with all guidelines with the exception of Guideline 35 relating to submission deadlines. The key reporting requirements in the Preparatory Guidelines are set out below.
28. Solo entities and groups representing at least an 80% market share / €12 billion assets threshold are required to report to the NCA specified narrative information and a subset of the quantitative reporting templates based on 31 December 2014 year end data within 22 weeks of the year end (28 weeks for groups).\(^{185}\)

29. Solo entities and groups representing at least a 50% market share / €12 billion assets threshold are required to provide to the NCA a subset of the Solvency II quarterly reporting templates on 30 September 2015 data within 8 weeks of the quarter end (14 weeks for groups).\(^{185}\)

30. The Preparatory Guidelines are silent as to what reporting will be required for the year ending 31 December 2015. The requirements for this will be dealt with through the Level 2 text for full Solvency II. The current text of these requires an opening balance sheet to be produced.

31. The key differences between the reporting requirements under the Preparatory Guidelines and the full Solvency II requirements are as follows:

► Only a subset of the annual and quarterly quantitative reporting templates is required – the subset is driven by the ECB financial stability reporting requirements and by which items are most stable;

► The volume of narrative information is substantially reduced;

► The requirement to take account of the structure of the insurer with reference to ring fenced funds (RFF) is maintained for the SCR calculation, but individual reporting is required only for the most material RFF, with the balance being aggregated;

► Groups using the deduction and aggregation method can use their own funds and capital requirements based on local rules for third-country subsidiaries rather than needing to recalculate on a Solvency II basis during the preparatory phase.

32. Those firms who will fall within the scope of the reporting requirements were expected to be notified by the end of January 2014.

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\(^{185}\) We understand that the PRA will not be asking firms for any reporting under the Preparatory Guidelines prior to 1 July 2015, though they would welcome earlier submission if available.
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