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INVESTMENT RULES AND PRACTICE IN THE LLOYD'S AND UK INSURANCE MARKETS

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Summary

This article discusses the investment rules that affect the assets in which UK insurers and participants in the Lloyd's insurance markets may invest. This includes both the applicable investment restrictions and the capital consequences that follow where an insurer invests in assets that are not admissible assets or invests in admissible assets to an extent exceeding applicable limits.

It also discusses the impact that Solvency II will have on these matters when it is implemented, focusing on the capital consequences of investment in particular types of assets. The relationship between asset portfolios and applicable capital requirements is one of the most controversial issues in the ongoing development of the Solvency II rules.

Introduction

In general, there are no restrictions on the types of assets in which UK insurers may invest. The main exception relates to the assets which cover linked business carried on by long-term insurers. In relation to that business, the policyholder benefits are linked to the value of particular assets held by the insurer. Such assets must be limited to "permitted links" (as defined in the FSA Handbook).

Nevertheless, investment in certain types of assets may have negative consequences for an insurer, affecting its position under the three regulatory pillars (Pillar 1: minimum capital requirements; Pillar 2: additional individually-determined capital requirements; Pillar 3: public disclosure). First, insurers (other than pure reinsurers) who invest in assets which are not "admissible assets", or who invest in admissible assets beyond certain asset and counterparty limits, are required to make deductions when calculating the amount of regulatory capital that they hold to meet their Pillar 1 and Pillar 2 capital requirements, and this will be reflected in their Pillar 3 disclosures. Second, inadmissible assets, and admissible assets in excess of the limits, are not eligible to cover insurance liabilities of an insurer (other than a pure reinsurer). Third, the assets held by an insurer will have a direct impact on its Pillar 2 capital requirement.

The rules that apply to participants in the Lloyd's insurance market depend on the context in which the investment is being made. UK-based assets held on behalf of a syndicate must comply with the requirements applicable to the relevant premiums trust funds (the funds into which premium income of Lloyd's syndicates is required to be paid), which are now broadly aligned with the list of admissible assets under FSA rules. Where these assets are transferred overseas to fund a regulatory deposit (for example, in respect of US surplus lines or reinsurance business), then local law investment requirements will apply.

A different set of rules applies to "funds at Lloyd's" – the assets which members of Lloyd's deposit with Lloyd's as a condition of being permitted to become or remain members of Lloyd's syndicates. These rules are in some respects narrower, and in other respects wider, than the list of admissible assets.

The Solvency II Directive[2] is due to create a new prudential regime for insurers in Europe from January 2014. When it is implemented, Solvency II will emphasise that member states may not impose specific investment restrictions on insurers, other than in certain circumstances in relation to linked business. This is subject to a specific investment restriction relating to investment in securitisations involving repackaged loans. Instead, a set of "prudent person" principles will apply to the investments that insurers may make. These principles are similar to those that already apply to pure reinsurers.

However, under Solvency II the capital requirement applicable to an insurer will be determined in part according to the assets held by that insurer, so that in theory the more risky the assets, the higher the capital requirement will be. This is similar to the manner in which the Pillar 2 capital requirement is currently determined. The exact calculation by which the relevant part of the capital requirement is determined is one of the most controversial issues in the ongoing development of the Solvency II rules.

For members of Lloyd's there is a further implication of Solvency II: because funds at Lloyd's are treated as capital, the limits that apply to "eligible own funds" will also apply to assets held as funds at Lloyd's. In particular, because letters of credit will be treated as tier two capital, they will not be permitted to constitute more than 50 per cent of the total capital of Lloyd's.

Lloyd's managing agents, Lloyd's members' agents and Lloyd's brokers are subject to rules which apply to them as individual legal entities (treated distinctly from their syndicates). These rules are not considered in this article.[3] This article also does not consider group-level implications arising from investments.[4]

Part I: UK insurers

Admissible assets and exposure limits

UK insurers, other than pure reinsurers[5], are subject to FSA rules which contain a list of "admissible assets" (contained in the FSA's General Prudential Sourcebook "GENPRU", chapter 2 Annex 7) and a list of asset and counterparty exposure limits (in the FSA's Prudential Sourcebook for Insurers "INSPRU" rule 2.1.22). With certain exceptions, there is no obligation to invest only in admissible assets or to keep exposures within applicable limits. However, where an insurer holds assets which are not admissible assets or holds admissible assets which give rise to an exposure exceeding the applicable limits, two consequences arise:

> First, the value of any inadmissible assets, or the part of the value of admissible assets in excess of the applicable limits, must be disregarded when assessing whether the

insurer has sufficient assets to cover its technical provisions[6] (INSPRU 1.1.20 and INSPRU 2.1.22(2)).

Second, the insurer must make a deduction when determining its capital resources (INSPRU 2.1.22(1)).

In extreme cases, these deductions could cause an insurer to breach the rule requiring it to ensure that its technical provisions are covered (INSPRU 1.1.20) or the rules requiring it to maintain adequate capital resources (GENPRU 1.2.26 and GENPRU 2.1.13). In any event they will reduce the buffer available to the insurer to protect it against breaches of these rules.

Admissible assets

The list of admissible assets includes bonds (referred to in the rules as "debt securities"), loans, shares, land and buildings. There is no requirement for bonds or shares to be confined to those that are dealt in on a regulated market (that is, to be listed). Certain other assets are included as admissible assets only where they meet certain conditions:

Collective investment schemes: Investments in collective investment schemes are included, but where the scheme is unregulated the insurer's investment must be sufficiently small to be consistent with a prudent overall investment strategy.[7]

Derivatives and quasi-derivatives[8]: Derivatives are included subject to conditions relating to their purpose (which must be reduction of investment risk or efficient portfolio management), the cover the insurer holds in respect of them (against future adverse variations which may affect the amount that the insurer may have to pay under them) and the ability of the insurer to value them and to close them out (see INSPRU 3.2.5).

Securities lending transactions[9]: Securities lending transactions are also included subject to conditions relating to the assets being lent (which must be admissible assets), the counterparty (which must normally be a regulated entity) and the collateral which is provided by the counterparty (see INSPRU 3.2.36).

It is possible for certain types of investment to fall within more than one category of admissible asset. For example, a credit linked note may be in the form of a bond, but it will normally also be a quasi-derivative. To address this scenario, the FSA rules require that assets be treated as falling within the three categories above even where they may also fall within another category, which means that the applicable conditions will apply.[10] It is therefore important to consider whether investments may fall within these three categories even if they are not intended to do so.

Examples of assets that are not admissible assets include works of art and commodities such as oil or gold, or derivatives based on them.

Exposure limits

Exposure limits set a limit on the degree of "exposure" arising from particular assets or particular counterparties by reason of the admissible assets that the insurer holds.

The "counterparty exposure" arising from an asset is the amount that the insurer would lose if a counterparty were to default (INSPRU 2.1.9(1)). The "asset exposure" arising from an asset is the amount that the insurer would lose if an asset were to become worthless (INSPRU 2.1.9(2)).

Often the exposure will be equal to the value of the asset or the claim against the counterparty, but this will not always be the case. For example, where the insurer holds collateral or benefits from a guarantee given by a third party, it may not suffer any loss unless the value of the collateral or the availability of the guarantee is also affected. In these circumstances, the insurer could therefore regard itself as having an exposure to the collateral or the guarantor rather than to the original asset or counterparty (see INSPRU 2.1.9(5), 2.1.35 and 2.1.36).

The key exposure limits are defined by reference to the insurer's "business amount", which is the amount of the insurer's technical provisions, other liabilities and capital resources. The limits vary according to the identity of the counterparty, the relationship of the firm to the counterparty and the nature of the asset.[11]

Certain assets are not subject to any limits. These include UCITS collective investment schemes and approved securities (see INSPRU 2.1.33). Approved securities are securities of Zone A countries[12] (such as UK gilts) or certain specified central banks.

One potential pitfall for insurers is the definition of "collective investment scheme" which excludes schemes in which the operator (the manager) is in the same corporate group as all of the participants.[13] This provision often results in schemes being structured with some element of third party investment to ensure that they will be treated as collective investment schemes.

Currency and localisation

With certain exceptions:

(a) INSPRU 3.1.53 requires that an insurer (other than a pure reinsurer) must hold assets in each currency of an amount equal to at least 80 per cent of the amount of its liabilities in that currency; and

(b) INSPRU 1.1.30 requires that the currency-matching assets required by INSPRU 3.1.53 must be held in any EEA State or in the country of the relevant currency (this is referred to as a "localisation" requirement).

Qualitative requirements

In addition to the specific requirements described above, UK insurers (other than pure reinsurers) are subject to certain qualitative requirements relating to their investments. In

particular, INSPRU 1.1.34 imposes requirements relating to safety, yield, marketability, diversity and spread, sufficiency, currency, and term.

With-profits funds

Insurers who carry on with-profits business (that is, insurance business in which policyholders are eligible to participate in the profits of the insurer as part of their policy benefits, normally in the form of discretionary bonuses) are required by the FSA's Conduct of Business Sourcebook ("COBS") to produce a document referred to as the Principles and Practices of Financial Management (referred to as a "PPFM").[14] The PPFM sets out how the insurer will manage its with-profits funds. Insurers are required to report annually to with-profits policyholders on the extent to which they have complied with the PPFM[15], and are subject to limitations when making amendments to the PPFM.[16]

The PPFM must include details of the investment management strategy that the insurer intends to apply to each with-profits fund.[17] Although this does not create a binding obligation to follow this investment management strategy, an insurer who deviates significantly from it without good reason may be considered to have treated its customers unfairly, in breach of Principle 6 of the FSA's Principles for Business.

With-profits insurers who have more than £500 million of with-profits liabilities (known as "realistic basis life firms") are required to calculate an additional component of their Pillar 1 capital requirement.[18] This component is known as the "with-profits insurance capital component" or "WPICC". The calculation of the WPICC involves a number of factors, including the "risk capital margin" which is determined based on how the value of the insurer's assets and liabilities would change in a number of future scenarios. These scenarios include specific scenarios affecting the market risk arising from UK and non-UK equities, real estate and fixed interest securities, and the credit risk arising from bonds, debts and derivatives.[19]

Life insurers with less than £500 million of with-profits liabilities

Life insurers which do not carry on with-profits business or which have less than £500 million of with-profits liabilities are known as "regulatory basis only life firms". They are required to calculate an additional component of their Pillar 1 capital requirement. This component is known as the "resilience capital requirement". Like the risk capital margin that forms part of the WPICC calculation for realistic basis life firms, it is calculated on the basis of how the value of the insurer's assets and liabilities would change in a number of future scenarios.[20] These scenarios are similar to, but not as complex as, the scenarios that apply for purposes of the risk capital margin.

Discounting liabilities

When calculating the present value of their insurance liabilities, long-term insurers are permitted to use a discount rate calculated by reference to the risk-adjusted yield that is expected to be achieved on their assets.[21] By holding assets with a higher risk-adjusted

yield, a higher discount rate can be used, meaning that the present value of the insurance liabilities will be lower. The risk-adjusted yield is therefore an important factor relevant to the selection of assets by long-term insurers.[22]

Pure reinsurers

It was noted above that the rules relating to admissible assets, exposure limits and currency matching and localisation, and the qualitative requirements of INSPRU 1.1.34, do not apply to pure reinsurers (that is, insurers who carry on only reinsurance business, and are not permitted to write any direct business).

Pure reinsurers are subject to a set of requirements relating to the way in which they invest their assets (see INSPRU 3.1.61A). These requirements do not include a list of assets or any quantitative limits, but instead impose qualitative requirements relating to sufficiency, liquidity, security, quality, profitability, matching, diversity and spread, and prudence, and the avoidance of excessive reliance on particular assets and counterparties.

Permitted links[23]

Under certain types of insurance policies, referred to as "linked" policies, the value of the benefits is linked to the value of assets identified in the policy. The assets may be specifically identified, but often they are the assets held by an insurer from time to time in one of its own internal funds (referred to as a "linked fund").

The assets to which the policy benefits are linked are required to be limited to the list of "permitted links" set out in COBS 21.3. This means that the insurer must ensure that the assets in a linked fund are limited to the permitted links, and there will be an automatic breach of an FSA rule if the insurer holds an asset that is not a permitted link in a linked fund.[24]

The main differences between the list of permitted links and the list of admissible assets is that the conditions that investments must satisfy in order to be included as permitted links are generally stricter. In particular:

(a) unlisted bonds and unlisted shares must be "realisable in the short term";

(b) land and property must be located in a territory with a properly functioning market, and are subject to a limit on borrowing;

(c) investments in unregulated collective investment schemes must be limited to collective investment schemes which invest only in assets that are permitted links[25], and are subject to a limit of 20 per cent of the gross assets of the linked fund in which they are held; and

(d) stock lending transactions must relate to assets that are permitted links.

The conditions applicable to derivatives are also different, though in certain respects they are more liberal than the conditions that must be satisfied for a derivative to be an admissible asset.[26]

Pillar 2 capital requirement

In addition to the ordinary capital resources requirement (the "CRR", also known as the "Pillar 1 capital requirement"), UK insurers are required by GENPRU 1.2.26 to satisfy a Pillar 2 capital requirement. To determine its Pillar 2 capital requirement, the insurer must produce an individual capital assessment (an "ICA") showing its assessment of the amount of capital that it would need to hold in order to remain solvent over a one year period with a probability of 99.5 per cent.[27] The FSA will then review the ICA and, if it thinks appropriate, give individual capital guidance ("ICG") to indicate any additional amount of capital that should be held.

For the most part, the ICA must be determined by use of a computer model, in accordance with guidance set out in INSPRU 7. However, as a benchmark for the ICA, UK insurers carrying on general insurance business must calculate an enhanced capital requirement (the "ECR"), one of the components of which is an "asset-related capital requirement".[28] Under INSPRU 2.2.11, the asset-related capital requirement is determined by applying capital charge factors to each of the insurer's admissible assets (though not to any part of the value exceeding the applicable counterparty and asset exposure limits).

The capital charge factors differ according to the perceived riskiness of each asset. For example, cash deposits with banks have a 0 per cent charge factor, bonds have a 3.5 per cent charge factor, land and buildings have a 7.5 per cent charge factor, and shares and investments in collective investment schemes have a charge factor of 16 per cent.[29] Where higher charge factors apply, the ECR will be higher and it is likely (though not certain) that the Pillar 2 Capital Requirement will therefore also be higher.

Part II: Lloyd's participants

Syndicate assets held in premiums trust funds

In the Lloyd's insurance market, managing agents are required to maintain premiums trust funds on behalf of the syndicates that they manage. These are the funds into which premiums are paid and out of which claims are paid. While assets are held in premiums trust funds, they are subject to investment in accordance with the applicable premiums trust deeds.

The premiums trust deed permits investment in any asset with the exception of five categories of "Excepted Investment" (contracts of insurance, rights under a stakeholder pension scheme, Lloyd's syndicate capacity, funeral plan contracts and regulated mortgage contracts). However, under INSPRU 2.1.42, the requirements of INSPRU 1.1.20 and INSPRU 2.1.22, discussed above in relation to UK insurers, also apply to Lloyd's syndicates. Two results follow:

> *Covering technical provisions*: Managing agents must ensure that the technical provisions of each year of account[30] of the syndicate are covered by admissible

assets which do not exceed the counterparty and asset exposure limits, with the limits applied as percentages of the syndicate admissible assets (rather than the business amount).[31]

Capital deduction applicable to syndicate: In determining the capital resources of a syndicate, managing agents must make a deduction of the value of inadmissible assets of the syndicate and of the part of the value of admissible assets that are held in excess of counterparty and asset exposure limits, with the limits applied as percentages of the admissible assets of the syndicate.[32]

Managing agents must produce an annual syndicate ICA in order to determine the amount of capital that is required in order for the syndicate to be able to meet all of its liabilities over a one year period with a probability of 99.5 per cent. Among other risks, this will reflect the market risk and counterparty risk arising from the assets of the syndicate. The syndicate ICA is produced by running a computer model, but Lloyd's has specified some example stress tests intended to support the conclusions of the ICA, which include the following[33]:

Test for shares: 50% fall in the value of shares

Test for bonds: 3% increase in interest rates (which would reduce the value of bonds)

Test for currency risk: 40% adverse major settlement currency move

Syndicate assets transferred to fund overseas business regulatory deposits

In relation to certain business written by a Lloyd's syndicate, it will be necessary for syndicate assets to be transferred to an overseas trust fund as an "overseas business regulatory deposit". The best known examples of such trust funds are those established in New York in respect of US reinsurance business (the "credit for reinsurance trust fund" or "CRTF") and US excess or surplus lines business (the "surplus lines trust fund" or "SLTF"). Assets transferred to these trust funds are held subject to trust deeds which require that the assets only be invested in assets which are "of a kind permitted under the insurance laws of the State of New York, or of other United States jurisdictions with substantially similar laws, in effect from time to time"[34], so it is necessary to consider New York law requirements.[35] Recent legislative reform in New York and Florida now permits Lloyd's syndicates to satisfy credit for reinsurance requirements in those states by deposits in separate trust funds which only need to be funded as to 20 per cent of gross liabilities, rather than 100 per cent.[36]

Similar trust deeds exist for assets held in respect of Australian, Canadian and South African business. In each case it is necessary to comply with the local legal and regulatory requirements regarding the permitted investments.

Funds at Lloyd's

As a condition of becoming or continuing as a member of a Lloyd's syndicate, a member is required to deposit assets with Lloyd's, known as funds at Lloyd's.[37] Funds at Lloyd's

may only be invested in a list of "acceptable assets" which is set out in Appendix 3 to the Lloyd's Membership and Underwriting Conditions and Requirements (Funds at Lloyd's).

The list of acceptable assets includes listed shares and listed bonds (but not unlisted shares or unlisted bonds) and certain other types of money and capital market instruments (subject to currency and rating conditions). Investments in collective investment schemes are permitted subject to the same conditions that apply to UK insurers, described above. The only type of derivatives that are permitted are forward currency contracts.

A key difference between the list of acceptable assets for funds at Lloyd's and the list of admissible assets for UK insurers is the inclusion of letters of credit and guarantees. A member of Lloyd's may arrange for a bank[38] to issue a letter of credit or guarantee in favour of Lloyd's, and thereby keep its own assets outside Lloyd's for investment free of the acceptable assets restrictions. Members of Lloyd's make significant use of this facility.[39]

Assets held as part of a member's funds at Lloyd's are not permitted to exceed the counterparty and asset exposure limits that apply to UK insurers, as described above, with the limits applied as percentages of the funds at Lloyd's of the member. The same exclusions from the limits apply to funds at Lloyd's as apply to UK insurers.[40] Letters of credit and guarantees are excluded from the limits at individual level, but Lloyd's is required to ensure that the total amount of letters of credit and guarantees issued by any one bank as funds at Lloyd's of all members do not exceed 20 per cent of the total funds at Lloyd's.[41]

Where a member is a member of a single syndicate and is the sole member of that syndicate, and is in the same corporate group as the managing agent of the syndicate, it is permitted to hold its funds at Lloyd's in its premiums trust funds rather than as a separate deposit with Lloyd's.[42] This arrangement is known at Lloyd's as "funds in syndicates". This arrangement has the advantage that the assets can then be invested according to the requirements applicable to premiums trust funds rather than the acceptable asset requirements. A disadvantage of this approach is that letters of credit and guarantees cannot be held in premiums trust funds.

Part III: Solvency II

Removal of investment requirements

When it is implemented[43] , Solvency II will prohibit member states from requiring insurers to limit their investment to particular types of assets.[44] It appears that this will also prevent them from imposing specific investment limits or consequences for investment in particular types of assets, although the European Commission will have power to lay down quantitative limits and asset eligibility criteria other than in

relation to linked business.[45] In addition, member states will not be permitted to impose localisation requirements requiring insurers to hold investments in the EU to cover insurance risks in the EU.[46]

An exception applies in relation to linked long-term business where natural persons bear the investment risk. In this case, member states will retain the discretion to impose restrictions on the types of assets to which policy benefits may be linked.[47] The FSA has indicated that it intends to use this discretion.[48] In addition, the Solvency II Directive imposes restrictions on investment in securities or instruments issued after 1 January 2011 which arise from the "repackaging" of loans.[49]

Instead of imposing specific investment requirements, member states will have to require their insurers to invest in accordance with the "prudent person" principles set out in article 132 of the Solvency II Directive. These principles include:

Risk assessment: The insurer must be able to identify, measure, monitor, control, report on and take into account the risks arising from the investments.

Quality: The investments must ensure the security, quality, liquidity and profitability of the portfolio as a whole, and be localised so as to ensure that they are available.

Matching: Assets which cover technical provisions must be invested in a manner appropriate to the nature and duration of the corresponding liabilities.

Best interest of policyholders: Assets which cover technical provisions must be invested in the best interest of policyholders and beneficiaries. This principle is potentially ambiguous and may be the cause of future dispute where an insurer wishes to increase the riskiness of its investment profile.

Derivatives: Derivatives must be used only for reduction of risks[50] or efficient portfolio management.

Unlisted assets: Investment in unlisted assets must be kept to prudent levels.

Diversification: Assets will have to be properly diversified to avoid excessive reliance on particular assets, issues, groups or geographical areas, or excessive risk concentration. Therefore, although the hard localisation requirements for assets covering EU risks will be abolished, the location in which assets are held will nevertheless remain relevant.

Capital consequences

Much like the approach that applies in the UK for purposes of determining the Pillar 2 capital requirement, Solvency II will impose a capital requirement (referred to as the "solvency capital requirement" or "SCR") which will depend on a determination of the amount of capital that an insurer would need to hold in order to remain solvent over a one year period with a probability of 99.5 per cent.[51] This will be calculated by a computer, either by applying a standard formula prescribed by an EU regulation to be made in accordance with Solvency II or by applying an internal model approved by the insurer's regulator.

Whether the SCR is calculated by the standard formula or by an internal model, it is intended to be risk sensitive, so that it will be higher if the insurer's investment portfolio exposes it to a greater amount of market or counterparty risk. The calibration of the standard formula and internal models are still being developed. The calibration of the capital charges that will apply to different types of assets in the standard formula is one of the most controversial issues arising from Solvency II.

Possible calibrations under consideration include charges of 39 per cent for listed equities, 49 per cent for unlisted equities and 25 per cent for property. For bonds, a charge based on rating and duration which would, for example, assign a charge of 14 per cent to an A-rated bond with a duration of 10 years and a charge of 45% to a B-rated bond with a duration of 6 years.[52] Holdings in collective investment schemes would be treated on a "look-through" basis, meaning that the capital requirements resulting from investment in a scheme would be determined by reference to the assets held in the scheme, as though held directly by the insurer to the extent of its investment in the scheme. Although a direct comparison is somewhat misleading, it is notable how much higher these charge factors are than those used by the FSA as described above.[53]

Impact on Lloyd's

The changes made by Solvency II will apply equally to Lloyd's participants. As a result, investment requirements will generally be removed and capital consequences will be imposed based on the market and counterparty risk arising from assets held by syndicates and as funds at Lloyd's. Capital requirements at Lloyd's are expected to be determined using a Lloyd's internal model which will incorporate information provided by syndicate models operated by managing agents.

Solvency II will have the effect of imposing a new limit in relation to funds at Lloyd's. Funds at Lloyd's are treated as capital of members of Lloyd's and so will constitute "own funds" for purposes of Solvency II. Currently, no limit applies to the aggregate amount of letters of credit that members of Lloyd's may include in their funds at Lloyd's. However, under Solvency II, letters of credit and guarantees will be treated as "tier 2" capital, which means that they, taken together with Lloyd's other tier 2 capital, will not be permitted to constitute more than 50 per cent of the total capital of Lloyd's. This may mean that Lloyd's is required to introduce a limit on the amount of funds at Lloyd's which may be provided by way of letter of credit.[54]

Endnotes

1 Steven specialises in financial regulation, with a particular focus on insurance and the Lloyd's insurance market. In addition to advisory and transactional work, he speaks regularly at conferences and has written published articles on a number of topics, including Solvency II. He is a contributing author to A Practitioner's Guide to the Regulation of Insurance (ed. John Young, 4th edition, Sweet and Maxwell, 2011). This article covers much of the same material as

a BILA lunchtime lecture given by the author on 17 February 2012. The slides presented at the lecture are available on the members section of the BILA website http://www.bila.org.uk/closed/cug/lecture_scripts.asp (log in and password required).

[2] EU Directive 2009/138/EC (the "Solvency II Directive").

[3] The financial resource requirements of Lloyd's managing agents and members' agents are set out in Lloyd's Capital and Solvency Requirements 2003 (attached to Lloyd's Market Bulletin Y3086, 30 June 2003). These contain requirements to make deductions from net assets in respect of certain types of investments. For example, 50 per cent of the amount of any unlisted investment is required to be deducted. Lloyd's brokers are required to comply with the FSA's Prudential Sourcebook for Mortgage and Home Finance Firms, and Insurance Intermediaries ("MIPRU").

[4] Special rules apply to the valuation of shares in and debts due from "regulated related undertakings": GENPRU 1.3.43. In addition, insurers are required to calculate their group capital position both in respect of the Pillar 1 and the Pillar 2 capital position: INSPRU 6 and GENPRU 1.2.45.

[5] A "pure reinsurer" is an insurer whose only business consists of reinsurance business. It is not permitted to write any direct insurance business.

[6] Broadly, "technical provisions" are the insurer's liabilities arising from its insurance contracts, such as outstanding claims provisions.

[7] See endnote 10 below.

[8] A quasi-derivative is an investment which has the effect of a derivative, such as a credit-linked note.

[9] A securities lending transaction is a transaction in which the insurer transfers shares or bonds to a counterparty subject to a requirement of the counterparty to return equivalent shares or bonds on a future date or, in some cases, on demand.

[10] GENPRU 2 Annex 7, paragraphs (2) and (3).

[11] The limits include the following:

Counterparty exposures to an individual or group of closely related individuals:

0.25 per cent of the business amount for the part of the exposure arising from unsecured debt, and 1 per cent for the whole exposure.

Counterparty exposures to "approved counterparties" or groups of closely related approved counterparties:

5 per cent for the part of the exposure not arising from covered bonds or short-term deposits, and 20 per cent for the whole exposure other than from covered bonds. 40 per cent for the part of the exposure arising from covered bonds.

(An approved counterparty is, broadly, an insurer, bank or investment firm regulated in the EEA. A covered bond is a special type of bond issued by a bank which, under applicable law, confers priority rights to certain assets of the bank. The 5 per cent can be increased to 10 per cent where the total of the exposures exceeding 5 per cent (to different approved counterparties and groups) is less than 40 per cent.)

Counterparty exposures to other persons (mainly companies) or groups of closely related persons: 1 per cent for the part of the exposure arising from unsecured debt. 1 per cent for shares and bonds that are not dealt in on a regulated market (i.e. they are not listed). 5 per cent for the whole exposure (including listed shares and bonds).

Asset exposure to unsecured debt of persons other than individuals and approved counterparties:

5 per cent: this applies on an aggregate basis, irrespective of whether the persons are closely related.

Asset exposure to unlisted shares and unlisted bonds:

10 per cent: this applies on an aggregate basis, irrespective of whether the persons are closely related.

Asset exposure to a piece of land or building:

10 per cent, but where two or more pieces of land or buildings are close enough to be considered effectively one investment then they will be subject to an aggregate 10 per cent limit.

Asset exposure to collective investment schemes:

UCITS: no limit. Non-UCITS retail scheme: 5 per cent. Other collective investment schemes: 1 per cent. (See also the admissibility requirement that the investment must be sufficiently small to be consistent with a prudent overall investment strategy (GENPRU 2 Annex 7, para (1)(A)(d)(iv)). In practice, it is likely that this requirement would be treated as an additional asset limit, so that the excess above the limit would be deducted from capital and ineligible to cover technical provisions, though a strict interpretation of the rules would result in the whole investment being deducted and ineligible.)

[12] A "Zone A country" is a country which is a member of the EEA or which is a full member of the OECD.

[13] Financial Services and Markets Act 2000 (Collective Investment Schemes) Order 2001, Schedule, paragraph 10.

[14] COBS 20.3.1.

[15] COBS 20.4.7.

[16] COBS 20.3.1(4) and (5).

[17] COBS 20.3.6(2).

[18] GENPRU 2.1.18 and GENPRU 2.1.19.

[19] INSPRU 1.3.44 et seq.

[20] INSPRU 3.1.9 et seq.

[21] INSPRU 3.1.28.

[22] In certain circumstances, general insurers are also permitted to apply discount rates in determining the present value of their liabilities. However, with certain exceptions, such as where a claim is required to be paid in the form of an annuity, any benefit of discounting is nullified by a requirement to make a deduction from capital resources of the difference between the discounted and undiscounted liabilities: GENPRU 2.2.107.

[23] This article only considers linked business where the link is to assets. Linked business can also consist in benefits which are linked to an index, in which case the index must be an "approved index" (as defined in the FSA Handbook).

[24] In this respect it differs from the rules relating to admissible assets and exposure limits, where holding assets which are inadmissible or exceed the limits may not necessarily result in the breach of any FSA rule.

[25] This requirement can be problematic where the investment fund is not established specifically for investment by insurers and is therefore not operated by reference to insurance requirements.

[26] For example, in relation to whether they are held for purposes of "efficient portfolio management" (see INSPRU 3.2.6).

[27] INSPRU 7.1.42.

[28] INSPRU 1.1.72B and INSPRU 1.1.72C.

[29] INSPRU 2.2.16.

[30] INSPRU 8.1.5.

[31] INSPRU 2.1.47.

[32] INSPRU 2.1.47.

[33] See Lloyd's Market Bulletin Y4256, dated 24 March 2009, attaching the 2010 ICA Minimum Standards and Guidance, which remain in force (see Lloyd's Market Bulletin Y4467, dated 2 February 2011).

[34] See paragraph 2.6 of each of the standard form US Credit for Reinsurance Trust Deed and the standard form US Excess of Surplus Lines Trust Deed.

[35] See 11 NYCRR 125 (Official Compilation of Codes, Rules and Regulation of the State of New York, Title 11, Part 125).

[36] See Lloyd's Market Bulletins Y4511, dated 19 August 2011 (New York), and Y4524, dated 7 October 2011 (Florida).

[37] Lloyd's Membership Byelaw (No. 5 of 2005), paragraph 16, and Lloyd's Membership and Underwriting Conditions and Requirements (Funds at Lloyd's), paragraph 4.

[38] Normally the letter of credit or guarantee is issued by a bank, but it can also be issued by a building society or (in theory) a life insurance company. The bank must be approved by Lloyd's for the purposes of issuing letters of credit as funds at Lloyd's.

[39] See Lloyd's Interim Report 2011, which indicates that, as at 30 June 2011, £7,127m out of a total of £14,470m of funds at Lloyd's (just under half of the total amount) was provided by way of letters of credit and bank guarantees.

[40] See above. The exclusions include UCITS collective investment schemes and approved securities.

[41] INSPRU 2.1.46(2).

[42] See Lloyd's Market Bulletin Y3946, 11 January 2007.

[43] It is currently expected that insurers will become required to comply with the requirements of Solvency II with effect from 1 January 2014.

[44] Solvency II Directive, article 133.

[45] Solvency II Directive, article 111(2).

[46] Solvency II Directive, article 134(1).

[47] Solvency II Directive, article 133(3).

[48] FSA Consultation Paper 11/23, November 2011.

[49] Solvency II Directive, article 135(2). For example, insurers will not be permitted to invest in the securities if the originator has not retained a net economic interest of at least 5 per cent.

[50] Note that the "reduction of risks" is wider than the corresponding current requirement which refers to "reduction of investment risks" (see Directive 92/49/EEC, article 21 and INSPRU 3.2.5).

[51] Solvency II Directive, article 101(3).

[52] See the technical specifications of Quantitative Impact Study 5 published by the European Commission, dated 5 July 2010.

[53] See endnote 28 above.

[54] See Lloyd's Interim Report 2011, which indicates that, as at 30 June 2011, Lloyd's capital included £7,127m of funds at Lloyd's and £932m of subordinated debt, all of which would be treated as tier 2 capital under Solvency II. Lloyd's had £9,298m of other capital. Assuming all of this other capital will be treated as tier 1 capital under Solvency II, the current ratio of tier 2 capital for Solvency II purposes would be approximately 46 per cent, which is close to the 50 per cent limit for tier 2 capital that will apply under Solvency II.