Financial Services Commission

Insurance Guidance Note No. 12

Insurance Companies Ordinance 1987

Guidance Notes On Linked Contracts

Date of Paper :	11th July 1997
Version Number :	V1.00
File Location :	document8

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Published by:

Financial Services Commission
PO Box 940, Suite 943, Europort, Gibraltar
Tel (+350) 40283
Fax (+350) 40282
E-Mail: info@fsc.gi
www.fsc.gi

Introduction

1 A linked long-term contract is one under which benefits are determined partly or wholly by reference to the value of specified assets or indices. A contract offering both linked and non-linked benefits is a linked contract.

2 The only permitted links are those set out in Part I (assets) and Part II (indices) of Schedule 3 to the Insurance Companies (Valuation of Assets and Liabilities) Regulations 1996 ("the Regulations") which must, where relevant, satisfy the conditions set out in Part III of Schedule 3.

3 The Regulations and the changes to the Insurance Companies Ordinance ("the Ordinance") introduced the permitted links rules. These give considerably flexibility over investments of linked funds. While we believe that this flexibility will be sufficient to meet the bulk of companies needs, we will consider sympathetically any reasonable representations to the effect that aspects of the regulations appear to be unnecessarily restrictive.

4 A linked contract will usually be written as Class III long-term business but may occasionally be written under other classes. As a general rule, this guidance applies in either case. However, the bulk of the "permitted links" rules (described in the sections on "Property to which benefits may be linked" and "Permitted indices for linked contracts") do not apply to linked Class VII business; but the "permitted derivatives" rules described in the section on "special considerations regarding the use of derivatives" apply to all linked contracts.

5 While companies will need to take their own legal advice, this guidance represents the Commissioner's view of the law following the changes to the regulations made up to March 1997. The guidance is not intended to be a complete description of the law governing linked contracts. Rather, it concentrates on those aspects which are relatively new or potentially problematical.

6 We do not consider that this guidance is relevant for the purposes of the Directors' certificate required under paragraph 7 of Schedule 5 to the Insurance Companies (Accounts and Statements) Regulations 1996.

Close Matching

7 By virtue of section 64B(2) and (3) of the Ordinance, the insurance company must hold assets whose value matches their unit liability as closely as possible. The corresponding provision in the Third Life Directive was drafted with the intention of prohibiting mismatching of the unit liability. This "close matching" test applies both to property-linked and index-linked contracts.

8 As a general rule, where the benefits are linked to the value of certain assets, a company is not permitted to hold different assets and cover the mismatching risk by means of a reserve. However, in certain circumstances, it is permissible for the insurer to hold assets other than any which determine the unit liability provided that they are "assets of appropriate safety and marketability" whose value matches those of the unit liability "as nearly as may be". This arises commonly in the case of index-linked contracts and also where the unit liability is partly or wholly reinsured.

9 Moreover, the "close-matching" test does not prevent surplus assets being kept within a linked fund (but see paragraph 38). Temporary and unplanned small shortfalls of assets which match the unit liability are also permitted provided that a satisfactory mismatching reserve is held.

Reinsurance Of The Unit Liability

10 The Regulations do not explicitly restrict reinsurance of the unit liability under linked contracts. Nevertheless, certain restrictions flow implicitly from the “close matching” requirement discussed above. The following paragraphs discuss 3 aspects of this requirement - “appropriate safety” (paragraphs 11 to 16), “as nearly as may be” (paragraph 17) and “appropriate marketability” (paragraph 18).

“Appropriate safety”

11 The right to receive reimbursement of the unit liability under a reinsurance contract cannot automatically be considered to be an asset “of appropriate safety” because of the risk, however small, that the reinsurer will default. In particular, we would not usually accept that a reinsurance contract from a reinsurer not supervised by an EEA State provided appropriate safety in this context, in the absence of additional guarantees such as the examples in paragraphs 12 and 13.

Deposit-back

12 It is clear that where the direct insurer arranges for deposit-back of the reinsurance premium and the contract is such that it has the legal right to retain the assets in the event of a reinsurance default, the required close matching can be achieved.

Reinsurance contract guaranteed by third party

13 As an alternative to deposit-back, the reinsurer may secure a third party guarantee from an approved credit institution which will enable the direct insurer to have recourse to that party in the event of a default by the reinsurer. This may satisfy the "appropriate safety" test provided that the credit-worthiness of the guarantor is satisfactory and provided that the terms of the guarantee are such that there is no likelihood that the direct insurer would have any difficulty in obtaining reimbursement from the guarantor if it were needed. We would not accept that a guarantee from anything other than an approved credit institution would provide "appropriate safety".

Reinsurance business regulated in Gibraltar or the UK

14 A reinsurance contract issued by a Gibraltar or UK-regulated reinsurer would usually provide "appropriate safety" for these purposes without any additional safeguards. This is not to say that such a contract can always be regarded as providing appropriate safety. If management has good reason to doubt the credit-worthiness of the reinsurer in question, such a contract cannot provide appropriate safety without additional safeguards such as those mentioned above.

Reinsurance business established outside Gibraltar or the UK

15 Outside Gibraltar or the UK, practices as to the supervision of reinsurance vary considerably amongst EEA States. In particular, our understanding is that pure reinsurers are rarely subject to supervision outside Gibraltar or the UK. The fact that the reinsurer is supervised (probably by virtue of writing direct business) may provide some comfort. But, unless it is clear that the financial security of the reinsurer is beyond reasonable doubt, we believe that some additional security (such as those mentioned in paragraphs 12 and 13 above) is necessary in order to satisfy the "appropriate safety" test.

Reinsurance within the group

16 It does not necessarily follow that, where the reinsurer is a member of the same group, "appropriate safety" is provided in all circumstances. However, many of the common situations have been covered above. Additionally, where the reinsurer is a regulated subsidiary of the ceding company, it may be possible to satisfy the "appropriate safety" test even without additional security.

"As nearly as may be"

17 In order to satisfy this requirement, the terms of the reinsurance contract must be such that the direct insurer would 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).

"Appropriate marketability"

18 The condition in paragraph 17, together with "appropriate safety", is also sufficient to ensure that the marketability is "appropriate" in the particular case of reinsurance. However, in other cases it could not be assumed that assets which matched the liability "as nearly as may be" were necessarily of appropriate marketability". Each case needs to be looked at on its merits.

19 Companies should review all their arrangements for reinsurance of linked liabilities to determine whether or not they satisfy the "close matching" test. If in doubt, the insurer should discuss the situation with the Insurance Supervisor, as there is a risk that they will be in breach of section 64B(2) of the Ordinance.

Index-Linked Contracts

20 In many cases, close-matching of index-linked contracts will give rise to no particular problem. For example, where benefits are linked to a stock index, it will normally be possible to transact an index derivative whose benefit structure matches that of the policyholder benefits exactly. In such cases, the "appropriate safety and marketability" tests should not however be taken for granted. As a general rule, an admissible derivative structure will satisfy the "appropriate marketability" test. But an over-the-counter (OTC) derivative would in general fall foul of the "appropriate safety" test, because of the concentration of exposure to one counterparty, unless steps are taken to diversify such exposure significantly. Margining or loan-back techniques, now fairly common, provide an effective remedy to this problem.

21 However, index derivatives are not always readily available. For example, derivatives based on the RPI are by no means commonly traded, even if a practical possibility. Where exact matching is not possible, we believe that the close-matching test can sometimes be satisfied by active management of a suitable portfolio of instruments which, in combination, provide the best matching readily achievable in practice. In the particular case of RPI-linked contracts, an appropriate combination (in the absence of RPI-linked derivatives) could be of index-linked gilts of different terms. However, active management of such a portfolio is essential in order to keep mismatching to a minimum. Without such active management, a significant mismatched position could easily build up quite quickly.

22 It is implicit in the "appropriate safety" test that the matching assets are admissible under Part II of the Regulations.

Index-Linked Class IV Contracts

23 By virtue of the interpretation of a "linked contract" in paragraph 1, a contract may be regarded as "index-linked" even if it would not fall under the usual understanding of an investment contract. In particular, a permanent health

contract which provides disability benefits which are guaranteed to rise in line with the RPI would be an index-linked contract and the close-matching rule described above would apply to the reserves held in respect of those benefits.

24 There is an apparent practical problem in that companies do not monitor on a continuous basis what their liabilities in respect of such benefits are. In such cases, we would expect that companies will:

- re-assess their liabilities regularly (once per quarter may be sufficient, depending on how quickly the book of business is evolving)
- hold an appropriate portfolio of index-linked instruments which provides a close match against the liabilities, as most recently assessed

Stock-Lending And REPO

25 Stock loans are not an explicit "permitted link" under the Regulations and it is therefore appropriate to consider whether the "close matching" test gives rise to problems with stock-lending by linked funds. We do not believe that there is such a problem with traditional forms of stock-lending, provided that accepted best practices are followed. Under the standard types of stock-lending agreement, the loans are made to institutions which are regulated. Moreover, they are fully collateralised either by securities which are not unduly volatile (relative to movements in the value of securities being lent), for example by a Talisman short-term certificate or by a guarantee from an approved credit institution. Further, they are returnable at very short notice. Providing that stock-lending meets these conditions, we believe that the assets held by the insurer are capable of satisfying the "close-matching" test. Where loans are made to institutions not subject to regulation, companies should satisfy themselves that the arrangements provide equivalent safety in all respects to that inherent in stock-lending to regulated institutions.

26 However, collateral whose value may diverge sharply from the value of the stock lent (e.g. a package of volatile equities as collateral for gilts), as a result of normal market fluctuations during the lifetime of the loan, should not be accepted. Some divergence in value between stock lent and collateral is to be expected. Regular (e.g. daily) adjustment of the collateral in line with market movements will, of course, mitigate this problem considerably. Moreover, collateral should be readily realisable. Otherwise, the assets covering the liability (that is, the promise to repay under the stock-lending agreement) cannot be considered to be "assets of appropriate safety and marketability".

27 As a general rule, collateral should be diversified, using the test at regulation 11(4)(b)(ii) ("not more than 15% exposure of the collateral to any one issuer or group") as a benchmark. The diversification test may be performed on the aggregate of collateral received by the fund, rather than separately for each deal. It must in principle be performed separately for each fund (although a company might reasonably choose to pro-rate its collateral across a number of funds). There is one exception to this diversification rule. If the collateral accepted represents assets that the fund could reasonably invest it, the diversification rule is irrelevant.

28 REPO arrangements for securities may in due course be commonly used in parallel with stock-lending. In principle, the regulations on linked funds should provide a level playing field for stock-lending and REPO arrangements. The considerations outlined above for stock-lending should apply to REPO also. However, a few points are worth highlighting.

Fixed Period Stock-Lending And REPO

29 We understand that fixed term asset exchanges are likely to be more common in the REPO market than the "return on demand" arrangements which are usual in current stock-lending agreements. Assets which have been REPO'd to another party for a matter of weeks or months can, in isolation, hardly be considered to be "of appropriate marketability" (from the point of view of the linked fund) during that period.

30 It is legitimate to take a view on marketability in the context of the total investments of that type. For example, a fixed interest fund which REPO'd 5% of its medium term gilts for a fixed period of 3 months but had no other REPO or stock-lending arrangements in place might reasonably be regarded as containing "appropriately marketable" securities; while this could not be said if the corresponding percentage were 25%. Each case will need to be considered on its merits. But the general principle is that fixed period REPO or stock-lending arrangements of more than a few days needs special justification.

Covered Transactions

31 Another point which stands out to a greater extent for REPO than for stock-lending (although the principle applies equally) is that the transaction must be covered (at least to the extent prescribed in regulation 11 in respect of transactions covered by the Asset Valuation Rules) at all times. Otherwise, the assets of the fund fail the "as nearly as may be" and "appropriate safety" tests. The considerations are very much the same as those for covered derivatives transactions, discussed in Insurance Guidance Note No. 11. Clearly, a company which receives cash in exchange for a gilt REPO is permitted to invest that cash. But it may only make investments which are guaranteed (barring unforeseeable circumstances) to deliver approximately enough cash to repurchase the gilts in accordance with the REPO agreement. Deposits at credit institutions or short-term fixed interest securities issued by organisations of good credit standing seem easily the most likely investments to satisfy the "as nearly as may be" and "appropriate safety" tests in these particular circumstances.

Stock-Lending/REPO And Policyholders' Reasonable Expectations

32 More generally, policyholders' reasonable expectations must be satisfied. The extent to which the long-term fund or the linked policyholders bear the investment risk of a counterparty default must be transparent. (Admittedly, this risk should usually be a very limited one in the case of stock-lending or REPO transactions which comply with the guidance above.) Where the linked policyholders bear the whole of the investment risk (assuming this to be consistent with the investment philosophy of the fund), they should receive the whole of the recompense (net of appropriate fees and expenses). Moreover, we are not aware of any circumstances where it would be appropriate for the lion's share of such net recompense to be allocated outside the linked fund, even where the whole of the risk of counterparty default is being borne outside the fund. This is because the linked assets have been earmarked for the benefit of the linked policyholders, albeit that they are not legally ring-fenced; fairness demands that the linked policyholders receive a reasonable share of any profits deriving from their use. Finally, under no circumstances could any part of the profits (as opposed to payment of fees or reimbursement of expenses) from stock-lending or REPO transactions on long-term assets be credited outside the company's Long-term Fund. In our view, this would represent a clear breach of section 83 of the Ordinance.

Impact Of The Asset Valuation Rules

33 Where the benefits under a linked policy are determined by reference to the value of specific assets, those ("property-linked") assets are exempt from the Asset Valuation Rules in Part II of the Regulations. The corresponding unit liability does not count towards the Long Term Business Amount.

34 Where the benefits are determined by reference to an index, the index-linked assets are subject to the Asset Valuation Rules. However, index linked assets are only partly subject to the diversification rules imposed by virtue of regulation 15 and Schedule 1. The permitted asset exposure limits set out in Part II of Schedule 1 do not apply to index-linked assets, but the permitted counterparty exposure limits do apply.

35 The corresponding unit liability counts towards the Long Term Business Amount, but only for the purpose of assessing compliance with the counterparty exposure limits. There are, therefore, 2 versions of the Long-Term Business Amount, depending on whether compliance with the permitted asset exposure limits or compliance with the counterparty exposure limits is being assessed.

36 Where an insurer holds assets in connection with a property-linked benefit but in excess of those required to match the unit liability, the excess assets are not property-linked assets. They are therefore subject to the Asset Valuation Rules for the purposes of assessing solvency (but not for assessing the amount of the unit liabilities). Similarly, excess holdings of assets over index-linked liabilities lose their exemption from the majority of Schedule 1.

37 Material excesses (such as where an insurer holds its otherwise non-linked equity portfolio as excess assets in its equity-linked fund) would need to be revalued in accordance with the Asset Valuation Rules. A material excess is one which satisfies either of the following tests:

(i) the value of the assets of the fund materially exceeds the unit liability of that fund

(ii) the total excess is material in the context of the Long-term Business Amount

Any consequent adjustment to the value of linked assets shown in Lines 85 and 86 of Form INS 5 should be detailed by a note to the return. (The revaluation is on the proportionate holdings the excess represents and can be performed on an approximate basis if the linked fund is broadly invested.)

38 Notwithstanding the comments above, an insurer will commonly hold linked assets whose value exceeds the amount of the unit liability. Where a fund has current liabilities, other than to policyholders, the unit liability will be determined by the value of the linked assets, net of the current liabilities. The difference here is that the insurer needs the additional assets in order to match the unit liability. They are not "excess" assets. Circumstances where this arises include the following:

(a) Debts are due to brokers in respect of linked assets which have been purchased but where settlement has not yet taken place

(b) The main linked asset is a derivative structure which has been collateralised by means of a loan which is re-invested by the company in money market instruments. In such a case, the money market instruments might or might not be linked assets, depending on how the contract with the policyholder had been constructed

Are Assets Index-Linked Or Property-Linked?

39 Where the insurer holds assets whose value mirrors that of a permitted index, it may not be immediately clear whether the assets are to be treated as property-linked or index-linked for the purposes of applying the Regulations. This is a point of some significance since the Asset Valuation Rules apply in the second case, but not in the first.

40 There is a simple rule for determining this question. 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 which 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.

41 A illustrative diagram is in the Appendix .

The Required Solvency Margin

42 If the insurer bears any type of investment risk , the required solvency margin is covered by paragraph 3 of Part I of Schedule 3 to the Insurance Companies (Solvency Margins and Guarantee Funds) Regulations 1996. If it bears no investment risk, the appropriate paragraphs are 4 and 5. Instances of an investment risk which the insurer may bear include:

(a) the risk that a counterparty to a derivative contract may default on its obligations; or

(b) the risk that a reinsurer may default on its obligations to reinsure the unit liability

43 Where there is an investment risk, paragraph 3 of Part I of Schedule 3 to the Insurance Companies (Solvency Margins and Guarantee Funds) Regulations 1996 applies only to that part of the linked liabilities which give rise to the investment risk. For example, where part of the linked liabilities is reinsured and an investment risk thereby arises, the 4% solvency margin applies only to the reinsured part of the liabilities.

44 As noted in the section on the “Impact of the Asset Valuation Rules”, the insurer always bears an investment risk in the case of index-linked contracts (even if only a counterparty risk). In the case of property-linked contracts, the insurer may or may not bear an investment risk, depending on the construction of the contract and the nature of any reinsurance arrangements.

45 The term "bears an investment risk” is not defined in the Regulations. The point is of practical significance when considering whether an investment risk can arise for the company as a result of reinsuring the linked liability or from a stock-lending agreement.

46 As regards reinsurance, the techniques for satisfying the "appropriate safety" test set out in the section on “Close Matching” would also go a long way towards ensuring that no investment risk arises for the purposes of paragraph 3 of Part I of Schedule 3 to the Insurance Companies (Solvency Margins and Guarantee Funds) Regulations 1996. In particular, barring special circumstances, the company's investment risk could be disregarded in the following circumstances:

(a) deposit-back or guarantee by approved credit institution, as discussed in paragraphs 12 and 13; or

(b) • reinsurer regulated in EEA State; and

- no reason to suspect the security of the reinsurer; and
- precise matching between unit liability and liabilities under the reinsurance contract; and
- the reinsurer itself holds assets which pass the close-matching test in respect of its liabilities under the relevant contract

47 Where stock-lending satisfies the "appropriate safety" test, as discussed in paragraphs 23 and 24, the company's investment risk can be disregarded. (Stock-lending which does not satisfy the test would of course be a breach of section 64B(2) of the Ordinance.) Nevertheless, there can clearly be rare circumstances where the counterparty's likelihood of honouring a stock-lending agreement is called into question sometime after the agreement comes into effect, even though the "appropriate safety" test had been satisfied originally. In such a case, the 4% solvency margin would apply.

Property To Which Benefits May Be Linked

48 The list of permitted links has been substantially updated following upon the Amendments made in March 1997. This section describes the changes.

Transferable Securities (Other Than Derivatives) - Paragraphs 1 & 2 Of Schedule 3

49 Securities are categorised as to whether they are:

- listed; and
- readily realisable,

in both cases, as defined for the purposes of Part II of the Regulations.

50 Securities which satisfy both criteria may be held in a linked fund without limit. Those which are unlisted may be held up to the limit of 10% of the unit liability of the fund, provided that they are readily realisable. Insurance Guidance Note No 4 on Asset Valuation gives more detail on how the "listed" and "readily realisable" criteria are to be interpreted.

51 In practice, the Commissioner may be prepared to make a statutory concession to allow the use of securities which are not readily realisable, particularly within the context of a collective investment fund investing in such assets (see paragraph 53), provided that the company is able to satisfy us:

- that the liquidity of the linked fund investing in such assets will be satisfactory; and
- that there is some reasonable basis for pricing units, given that such investments are not readily realisable

Collective Investment Funds - Paragraph 5 Of Schedule 3

52 The rules in this area have been relaxed in the regulatory amendments made in 1997. A wide category of collective investment funds may now qualify as permitted links. The term is not explicitly defined although it goes wider than collective investment schemes, as defined in the Financial Services Ordinance. The rules cover 2 categories of fund:

schemes (whether in the form of unit trusts or open-ended investment company) which meet the requirements to be a UCITS (irrespective of whether they have applied for and been granted the "single passport"), as set out in the UCITS Directive; and

- other collective investment funds which satisfy certain additional requirements

53 The additional requirements to be satisfied by non-UCITS funds are:

- they invest in assets all of which are themselves permitted links;
- the holdings may be readily sold to or purchased from the managers at a price which represents net asset value;
- the sale or purchase price is published regularly; and
- the linked contracts have been marketed in accordance with any restrictions which apply to the marketing of the collective investment funds unless such funds represent less than 10% of the unit liability under the linked contracts

Funds which are listed but not authorised (or recognised) under the Financial Services Ordinance.

54 All authorised or recognised unit trusts (as defined in the Financial Services Ordinance) fall under one or other of the criteria of paragraph 51 above. However, the criteria of paragraph 52 go wider than that and include collective investment schemes which are regulated offshore but which are not "recognised unit trusts". Some of those schemes originally qualified as permitted links by virtue of being listed on an EEA stock exchange. However, they are very unlikely to meet the definition of "readily realisable" even if listed. Therefore, such schemes need to qualify under the criteria of paragraph 52 to retain their status as permitted links (without limit). (They may, of course, be eligible to be treated as listed securities, not readily realisable. In this case, they would be permitted links, subject to the 10% limit described in paragraph 50.)

Linked funds of another insurer

55 We believe that a linked fund of another insurer would usually qualify under paragraph 5(b) of Schedule 3. This is of practical significance since a number of insurers offer "self-invested" plans where the policyholder makes his own investment arrangements. Some may wish to expose themselves to the investment performance of an insurer other than the plan provider.

56 However, there is a potential problem in this area. Except where the contract between policyholder and first insurer is a Class VII managed pension contract, our view is that the second insurer would be in breach of section 21 of the Ordinance if it accepted such funds for investment; such activity is neither insurance business nor in connection with or for the purposes of its insurance business. (This issue does not however arise if the first insurer reinsures the investment liability to the second insurer under a contract of insurance.)

Derivatives And Quasi-Derivatives - Paragraphs 9, 14 And 16(d) Of Schedule 3

57 Derivative contracts may be used in linked funds, subject to the special considerations described later in section on "Special considerations regarding the use of derivatives in linked funds". Contracts or assets which have the effect of a derivative contract may be used only if the corresponding (hypothetical) derivative contract would be a permitted link. Guidance on the types of contract which are considered to have the effect of a derivative contract is given in Insurance Guidance Note No. 11 dealing with derivatives.

Broker Funds - Paragraph 11 Of Schedule 3

58 Collective investment funds managed by intermediaries and accessible only through the medium of a linked life policy ("broker funds") are unlikely to satisfy the requirements described in paragraph 52. Nevertheless, these can still be permitted links by virtue of paragraph 11 of Schedule 3 which sets a condition that the insurance company must accept responsibility for errors and omissions of the intermediary towards the policyholder. The "look-through" requirement described in paragraph 59 has now been applied to these funds.

Look-Through - Paragraph 16(a) Of Schedule 3

59 A look-through rule applies to securities (other than those which are listed and readily realisable), to collective investment funds (including broker funds) and to debts due from approved credit institutions and investment firms to determine whether the link is permissible. However, collective investment funds “falling within the UCITS Directive” are exempt from look-through.

Bank accounts with returns linked to an external reference value

60 It is not possible to link to an account at a bank.

Collective investment funds investing in non-permitted links

61 Similarly, it will be illegal to link to collective investment funds (other than UCITS) which invest in property which would not itself be a permitted link. One such example would be where a unit trust (other than a UCITS) invested directly in gold or other commodities.

Funds "falling within the UCITS Directive”

62 We take the view that this phrase (which occurs in paragraph 5(a) of Schedule 3 and which determines whether or not look-through is necessary) refers to those schemes which fulfil the minimum requirements set out in that Directive to receive the "single passport", whether or not they have applied for that status.

Futures and Options Funds

63 One specific point which has been raised is whether a Futures and Options Fund (FOF) can be a permitted link. FOFs are subject to the look-through requirement. A particular issue concerns the use of derivatives within a FOF. Provided this is consistent with the interpretation of efficient portfolio management or reduction of investment risks set out in Insurance Guidance Note No. 11 (and satisfies all the other conditions which apply to permitted derivative contracts), this would not prevent a FOF from being a permitted link. Geared futures and options funds (GFOFs) cannot satisfy those conditions and therefore cannot be a permitted link.

Permitted Indices For Linked Contracts

64 Part III of Schedule 3 to the Regulations sets out criteria which an index must satisfy in order to be a permitted link.

65 Equity indices on the basis of which index options or futures are traded on a regulated market qualify by virtue of paragraph 13(c) of Schedule 3 to the Regulations. The main indices of other significant stock markets will satisfy the conditions of paragraph 13(b). While linkage to a matched basket of equities can give a roughly comparable effect to linkage to other indices which do not satisfy the above-mentioned criteria, marketing of such index linkage would be illegal.

Special Considerations Regarding The Use Of Derivatives (And Quasi-Derivatives) In Linked Funds

66 Derivative instruments are permitted links only if they satisfy each of the seven conditions set out below:

(a) are regularly traded on a regulated market or with an approved counterparty

(b) are capable of being readily closed out

(c) are for the purposes of reduction of investment risks or efficient portfolio management

(d) satisfy the "in connection with" test

(e) are based on underlying assets which are themselves permitted links

(f) are covered

(g) satisfy the prescribed pricing basis

67 The considerations are very similar to those which determine whether or not a derivative in a non-linked fund is an admissible asset. Guidance can be found in Insurance Guidance Note No. 11. There is however one significant difference between the use of derivatives in linked and non-linked funds. Use in a linked fund of a derivative which did not satisfy the conditions in paragraph 66 above would be illegal.

Margining And Collateralisation

68 Companies should margin or collateralise their derivative contracts wherever appropriate as a means of reducing credit exposure of the fund to the company's counterparty. (Indeed, in some cases this may be a necessary pre-requisite for a contract to count as reduction of risks or efficient portfolio management). However, margining cannot under any circumstances legitimise the use of a contract which is not a permitted derivative contract and whose use in linked funds is, therefore, illegal.

69 The use of margined derivative contracts is illegal under the Regulations, unless such contracts are "permitted derivative contracts".

Quasi-Derivatives

70 Instruments, which have the equivalent effect of derivative contracts, of whatever legal form, may be permitted links only if the effect is equivalent to that of a permitted derivative contract. Thus, for example, an instrument which had the effect of a highly geared derivative contract, whose use was not consistent with efficient portfolio management, could not be a permitted link even if it took some other legal form - say, that of a listed security.

71 Some securities (for example, equity shares in gold mining companies) have a rather similar effect to derivative contracts. The question has arisen whether such shares "have the effect of" a gold future; the trading price of the shares will be fairly highly correlated with the price of gold. It is clear, however, that these shares do not satisfy the criteria in the regulations for "assets which have the effect of a derivative contract". Their effect may be similar to that of a derivative. But it is not equivalent since the share price would also be expected to depend significantly on factors internal to the company.

Diversification Of Assets

Explicit Diversification Requirements

72 As a general rule, there is no requirement for diversification of assets in linked funds. There are some explicit exceptions, however. Securities which are unlisted (or listed but not readily realisable) may not account in aggregate for more than 10% of the linked benefits under a contract. A similar percentage limit applies to holdings in collective investment schemes other than:

- those qualified to be UCITS; or
- those which have been marketed to the policyholder in accordance with the marketing rules which apply to the collective investment schemes in question

Implicit Diversification Requirements Derived From Marketing Material

73 There are also some important implicit requirements for diversification, derived from the wording of the marketing material used. In assessing any possible breach of policyholders' reasonable expectations in this area, the Commissioner would, of course pay, attention to the letter of the wording. But he would equally pay due regard to its sense.

74 For example, a company offers a linked contract which is designed to deliver income 7% per annum net. Inspection of the marketing material reveals the following statement, which is given reasonable prominence:

> **The fund will be invested in assets offered by major financial institutions. In the unlikely event that one of these institutions defaults on its obligations, you may receive less than promised above.**

75 We consider that such wording, in particular the use of the phrase "major financial institutions" conveys an expectation of a reasonable level of diversification. Once counterparty would be completely unacceptable in this case. It would be even less acceptable if that counterparty turned out to be a connected company of the insurance company, however major a financial institution that connected company happened to be.

Counterparty Exposure And Derivatives

76 There may also be an implicit requirement for diversification of counterparty exposure arising from the use of derivatives, in particular where derivatives are used to provide a precise match to the promised policyholder benefits. The situation is not entirely straightforward as not all linked contracts which use derivatives to provide precise matching need the counterparty risk to be diversified (although this may still be a sensible course in some cases, even if not absolutely required by the regulations). To distinguish between the cases, it is necessary to go back to the first principles governing use of derivatives in linked funds set out in Insurance Guidance Note No. 11.

77 As set out in paragraph 66 above, derivatives may be permitted links only if they satisfy a number of conditions, including the rule that they must be used only for the purposes of reduction of investment risks or efficient portfolio management. According to that interpretation, if the use of derivatives brings with it any significant additional risk, such use is incompatible with "reduction of risks" or "efficient portfolio management".

78 A significant risk is one where there is a reasonably foreseeable risk of significant loss, either to the company or to the policyholder. It follows from this that:

- where a company uses derivatives to match benefits under index-linked contracts, counterparty risk diversification is necessary to preserve a comfortable solvency position, for the company or to avoid the risk of a large reduction in solvency cover (after making due allowance for any contingent obligation which the insurer may be liable to fulfil).
- where a concentration of counterparty risk is inherent in (or usual for) the type of contract in question and use of derivatives gives rise to essentially the same counterparty risk, counterparty risk diversification is not required.

79 Where there is significant counterparty exposure, an assessment must be carried out of whether or not it is the use of derivatives which gives rise to such exposure. For a property-linked contract, "significance" is to be viewed in the context of the size of the linked fund (i.e. the effect of a counterparty failure on the policyholder benefits). The threshold of significance will vary according to the nature of the contract.

80 A FTSE tracker fund would not traditionally have built up counterparty exposures beyond a few per cent of the value of the fund, determined by the market capitalisation of the biggest companies contributing to the index. Where derivatives are used to replicate the index, counterparty exposure of a similar size (say 5% of the value of the Fund) would therefore be regarded as significant.

81 At the other extreme, a company might offer a "ABC Bank fixed interest plus" fund, offering (assuming that ABC Bank meets its obligations in full) something close to the market rate for fixed interest contracts, together with a small participation in the upside of equity markets. Such a contract would probably rely on use of derivatives. In substance, the benefits are very close to an "ABC Bank fixed interest fund" which would, of course, be a perfectly acceptable property-linked fund, even without any diversification of counterparty exposure, if properly explained to prospective policyholders. In the case of such a "fixed interest plus" fund, therefore, although there is concentration of counterparty risk exposure, it is reasonable to conclude the use of derivatives is incidental to this concentration.

82 The following assessment procedure appears to be a practical one for assessing whether the derivatives have given rise to significant counterparty risk:

- First, consider how the benefits could be provided if derivatives were not used and what would be the resulting counterparty exposure.
- In cases where the precise benefit structure can be achieved only with derivatives, consider the counterparty exposure (in the absence of derivatives) under broadly equivalent benefit structures provided without use of derivatives. (Such a broadly equivalent structure must exist or else there is no real prospect of satisfying the "efficient portfolio management" or "reduction of risks" tests.)
- Finally, compare the counterparty exposure in the "with derivatives" and "without derivatives" cases. It will be apparent whether use of derivatives has given rise to significant additional counterparty exposure or whether such exposure would exist without derivatives.

83 Examples of contracts where the use of derivatives does - or does not-give rise to significant counterparty risk are at paragraphs 81 and 82 above. In practice,

structures intermediate between these two extremes are common; some of the counterparty risk concentration may be inherent in the benefit structure while use of derivatives gives rise to additional concentration of risk. While it would be theoretically possible to attempt to apportion the risk between these two causes, we do not recommend this as a practical procedure. In such cases, the company should take the view that the whole of the counterparty risk needs to be diversified.

84 Although the above paragraph recommends erring on the side of counterparty risk diversification, this still does not mean that risk diversification is necessary for all contracts which use derivatives for precise matching. We suggest the following rule of thumb. A contract may be considered to be a "fixed interest contract" if the benefits approximate to the benefits which would be receivable if the fund invested in appropriate fixed interest securities. "Fixed interest contracts" which use derivatives will therefore not require counterparty exposure reduction techniques under the "derivatives rules" - although such techniques may be necessary for other reasons, for example to reflect what the policyholder has been told, or not told, about the nature of the risks.

85 In the absence of special justification, contracts which

- use derivatives; and
- where (in the absence of counterparty exposure reduction techniques) it is reasonably foreseeable that the return will be less than that of "fixed interest contracts"

will require such techniques. In this context:

- “approximate to" means that the gross redemption yield will not be more than 1 percentage point less, as far as can reasonably be foreseen, than the rate for a fund which invests in appropriate fixed interest securities
- "benefits receivable" need only be considered at maturity date for a fixed-period bond but need to be considered on any day where switches are permitted from the respective linked fund to another fund
- “appropriate fixed interest securities" would be securities issued by a sovereign or supra-national issuer, denominated in the appropriate currency and of similar term to the length of the contract

Management Of Risk Concentrations

86 Where derivatives naturally give rise to a counterparty exposure which is significant (in the above terms), this must be managed appropriately to allow the "efficient portfolio management" test to be satisfied. There are various techniques for this, including margining and collateralisation. However, these techniques are effective for these purposes only if they achieve:

- substantial risk diversification; or
- transfer of counterparty risk from the original counterparty to a "risk-free" sovereign or supranational issuer (e.g. collateralisation by UK gilts)

87 In this context, "substantial risk diversification" means that the additional counterparty risk arising from use of derivatives must be reduced as far as practicable. Residual counterparty exposure, after risk diversification, to the extent of 20% of the value of the fund could be acceptable but:

- only just acceptable; and

- acceptable only if it would be unduly onerous to reduce it further

88 It would be reasonable to take into account the size of the fund in assessing whether or not a further reduction in maximum counterparty exposure was unduly onerous; but a small fund is not entitled to ignore the 20% limit on the grounds that its small size means that diversification poses severe practical problems.

89 For example, consider a contract where derivatives are used to give a precise match to the benefits promised, and

- where the contract was not a "fixed interest contract", in the terms mentioned in paragraph 85 above; and
- where use of derivatives unarguably gives rise to significant counterparty risk concentration; and
- where, on reasonable assumptions, the maximum single counterparty exposure was expected to be between 40% and 60% of the net value of the fund and other counterparty exposures would be insignificant.

As noted in paragraph 83 above, the Commissioner would not encourage companies to attempt to attribute the single counterparty exposure between "caused by derivatives" and "not caused by derivatives". Further, the Commissioner believes that it will not usually be unduly onerous to arrange for margining and spread the margined amounts amongst securities issued by 4 or 5 different issuers. That should mean that the maximum counterparty concentration arising from derivatives would not be expected to exceed 12% of the value of the fund.

Fallacies

90 It has been argued that the "efficient portfolio management" test is automatically satisfied if the policyholder has been told that there will be significant counterparty exposure as a result of the use of derivatives. This is fallacious. The test is an independent one and therefore does not depend on what the policyholder has or has not been told. (By analogy, the fact that a policyholder may have been told that his benefits will be linked to the price of gold does not make gold a permitted link!)

91 It has also been argued that there would normally be 100% exposure to a particular counterparty in the case of a property-linked deposit fund; and that therefore 100% exposure to a banking group in the case of a property-linked fund which uses derivative structures to give equity-like performance is equally acceptable. This is also fallacious. Derivatives are required to satisfy the above-mentioned tests. The requirements derive from the EC Third Life Directive and cannot be waived.

92 Further, it has been argued that where the counterparty has a high credit rating, there is no need to consider the counterparty risk. Again, this is a fallacy. The mathematical expectation of loss is not the key determinant of "risk" to be taken into account here. Even though a highly-rated counterparty is most unlikely to fail, if the linked fund is substantially or completely exposed to that counterpany, the effect on policyholder benefits will be catastrophic. While it would be perfectly reasonable to use credit rating to decide which counterparties to deal with and for the purpose of setting maximum exposure limits, it is not reasonable to disregard the risk completely. A sensible spread of exposure amongst counterparties of acceptably high rating will strike a reasonable balance between the competing objectives of maintaining counterparty quality and keeping the consequences of a single catastrophic failure within acceptable bounds.

93 There are two other points worth mentioning. First, "counterparty exposure reduction" does not necessarily mean "removal". It is acceptable to have some counterparty exposure to the derivatives counterparty. Second, counterparty exposure reduction" does not mean "transfer". Arranging for margin (or collateral), only to invest it wholly in the securities of one particular issuer no more achieves efficient portfolio management or reduction of investment risks than leaving the contract unmargined.

Counterparty Exposure Arising From Use Of Derivatives In Asset Management

94 High concentrations of counterparty exposure do not usually arise from the traditional use of derivatives in asset management, for example:

- to effect an immediate switch of exposure from one asset class to another; or
- to hedge a position with an exchange traded option.

Even if a major portion of the fund's assets is being switched or hedged, the transaction is normally fairly short-term in nature which limits the scope for large exposures to build up. However, the principle is the same as that discussed above. A significant exposure, interpreted as in paragraph 88 above, would be inconsistent with efficient portfolio management.

Counterparty Exposure In Property Linked Contracts And The "Reduction Of Risks" Test

95 In the above paragraphs, we argued that significant counterparty exposure was inconsistent with the "permitted links rules" where derivatives are being used for "efficient portfolio management" of equity-type assets. However, where a derivative is genuinely being used to reduce risks, a significant counterparty exposure could easily arise if the adverse event insured against actually comes to pass. Although this counterparty risk would not exist but for the use of derivatives, the fund will be no worse off than if the derivative had not been transacted. In such cases, there is no absolute requirement to diversify the counterparty risk in advance. However, we would consider that some diversification mechanism (such as margining) is a normal prudent practice. And to the extent that the derivative underpins some non-linked benefit offered under the contract (such as a guarantee of investment performance), it would be essential.

96 While it is sometimes not very clear whether a contract is for the purposes of "efficient portfolio management" or "reduction of risks", we are clear that use of derivatives which introduces new risks does not fall into either category Thus, for example, an asset structure which provides:

- performance in line with FT-SE 100, apart from
- a floor on performance if FT-SE falls, and
- concentrated exposure to the derivatives counterparty

is not justifiable under these headings, except as a small component of a diversified fund. Although market risk is being reduced, this does not provide justification for the significant increase in counterparty risk (compared with "traditional" investment in a basket of equities) to be overlooked.

Counterparty Exposure And Index-Linked Or Non-Linked Contracts

97 The remarks in the preceding paragraphs apply mainly to counterparty exposure in the context of property linked funds. Where a "guaranteed" or

similar product is arranged as an index-linked or non-linked contract, the significance of any counterparty exposure has to be viewed in the context of the totality of the non-linked assets. A company should, as a matter of course, have a policy on the maximum acceptable counterparty exposure for any counterparty it deals with. Provided this is a prudent limit, in the context of the considerations mentioned in paragraph 78 above, counterparty exposure is unlikely to give rise to failure of the "efficient portfolio management" or "reduction of risks" tests.

Non-Permitted Links

98 From time to time, an insurer may find that a linked fund contains assets which are not permitted links, either as a result of unforeseeable circumstances or of error on the part of the fund manager. The Regulations set an absolute requirement. Such an occurrence is illegal. We therefore expect insurers to take all reasonable steps to ensure that such an occurrence is not reasonably foreseeable.

99 For example, consider the 10% limit for unlisted securities. It would be unacceptable for a manager to plan to have a holding of 9.9% in unlisted securities; a normal market movement could easily lead to a breach of the limit. But the manager is not required to foresee that the value of a particular security might multiply several-fold in value in a very short period, even though this is not absolutely impossible.

100 Nevertheless, if such an event happens, it must be managed. If it does, we would expect the insurer to take the following steps:

(a) where such a breach occurs as a result of unforeseeable circumstances, it must be repaired without delay; and

(b) where a breach has occurred whose possibility was reasonably foreseeable or which was not (for whatever reason) repaired without delay, and if such breach has led to a reduction in the net assets of the fund and it was reasonably foreseeable that this could be the result, the notion of policyholders' reasonable expectations demands that the company should make good the loss; and

(c) inform the Insurance Supervisor and the company's auditors as to the steps it proposed to take.