

CP11/23***

Financial Services Authority

Solvency II and linked long-term insurance business

November 2011

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The Financial Services Authority invites comments on this Consultation Paper. Comments should reach us by 15 February 2012.

Comments may be sent by electronic submission using the form on the FSA's website at: www.fsa.gov.uk/Pages/Library/Policy/CP/2011/cp11_23_response.shtml.

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A confidential response may be requested from us under the Freedom of Information Act 2000. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the Information Commissioner and the Information Tribunal.

Copies of this Consultation Paper are available to download from our website – www.fsa.gov.uk. Alternatively, paper copies can be obtained by calling the FSA order line: 0845 608 2372.

Abbreviations used in this paper

CBA	cost benefit analysis
CDS	credit default swaps
CIS	collective investment schemes
CLD	Consolidated Life Directive 2002/83/EC
COBS	Conduct of Business sourcebook (FSA Handbook)
COLL	Collective Investment Schemes sourcebook (FSA Handbook)
CP	Consultation paper
DC	Defined contribution
EEA	European Economic Area
EIOPA	European Insurance and Occupational Pensions Authority
FCA	Financial Conduct Authority
FSCS	Financial Services Compensation Scheme
FSMA	Financial Services and Markets Act 2000
GENPRU	General Prudential sourcebook (FSA Handbook)
INSPRU	Prudential sourcebook for Insurers (FSA Handbook)
IPRU (FSOC)	Interim Prudential sourcebook for Friendly Societies (FSA Handbook)
IPRU (INS)	Interim Prudential sourcebook for Insurers (FSA Handbook)
NURS	non-UCITS retail scheme

ORSA	Own Risk and Solvency Assessment
PRA	Prudential Regulation Authority
PS	Policy statement
RMBS	residential mortgage-backed securities
Solvency II	EU Directive 2009/138/EC which will replace the Consolidated Life Directive
SOLPRU	the new FSA prudential sourcebook replacing INSPRU and elements of GENPRU related to insurance and reinsurance undertakings
SYSC	Senior Management Arrangements, Systems and Controls sourcebook (FSA Handbook)
uCIS	unregulated collective investment schemes
UCITS	undertakings for collective investment in transferable securities
UCITS IV	revised UCITS Directive
QIS	Qualified Investor Schemes

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Overview

- 1.1** The purpose of this consultation paper (CP) is to present proposals for changes to our rules and guidance relating to the operation of unit-linked and index-linked insurance policies, primarily in the Conduct of Business Sourcebook (COBS) 21, *Permitted Links*. The proposed changes outlined in this chapter are intended to reform the current rules, so that they are consistent with the requirements of Solvency II.
- 1.2** The proposed Handbook rules included in the Appendix of this paper will come into force at the same time as the other rules for Solvency II. We expect the revised rules to take effect when Solvency II is fully implemented and the requirements of the Consolidated Life Directive are withdrawn. Full details on the FSA's Solvency II consultation process and on the nature of the Directive can be found in CP11/22, *Transposition of Solvency II – Part 1*, which is also being published today as part of stage 1 of the transposition. This overview sets out information relevant to the changes outlined in this CP.

Scope of this consultation

- 1.3** This CP confines itself to the issues described in paragraph 1.1 above. Other conduct of business issues relating to the effect of Solvency II on firms operating with-profits funds and some outstanding issues in relation to COBS 21 will be covered in a further CP to be published next year.
- 1.4** The current handbook sourcebooks and provisions will remain in place for non-directive firms. The Handbook as applicable for non-directive firms will be addressed after the implementation of Solvency II.

Who should read this consultation paper?

- 1.5** This chapter is directly relevant to all firms writing new linked long-term business or with existing books of linked long-term business.

CONSUMERS

This consultation is relevant to consumers with linked long-term policies, their advisers and consumer groups.

Next steps:

- 1.6 This consultation will close on 15 February 2012. We will then finalise the draft rules and guidance in light of the responses to this CP. Our intention is to publish a Policy Statement giving feedback in the second quarter of 2012.

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Our proposals

- 2.1** The rules and guidance in COBS 21 represent a form of product regulation. The products to which they apply transfer risks to policyholders or beneficiaries. So when risks of this type materialise, they manifest themselves as consumer detriment long before they present any material issue in relation to the firm's profitability or solvency.
- 2.2** The latest published figures show the UK unit-linked long-term life sector has managed assets of £815¹ billion related to benefits under unit-linked policies – by far the biggest sector of the insurance industry. The investment risk of these assets is borne by the policyholder, not the insurer. A further £24 billion of assets relates to index-linked policies.
- 2.3** Given that under unit-linked policies, it is the policyholder and not the insurer who will suffer detriment if the assets backing the policy turn out to be inappropriately risky, the management of assets and reference values is a matter of regulatory interest. Much of the growth in unit-linked funds in recent years has been driven by the growing popularity of defined contribution (DC) pension schemes and we expect this to continue with the introduction of auto-enrolment² in 2013.
- 2.4** Our regulatory concern is the appropriateness of this transfer of risk to different categories of policyholder.
- 2.5** We believe it is vital that we are able to continue to provide an appropriate level of protection to policyholders under Solvency II. The proposals described in this chapter are intended to achieve that aim within the framework of Solvency II.

The current rules

- 2.6** To understand how COBS 21 will need to be amended to achieve the aims of the Solvency II Directive, it is helpful to describe its current structure, which is divided into three sections:

1 Source: SynThesys Life 2010: Figures for year end from Form 13 Line 59.

2 Auto-enrolment means workers being automatically enrolled into their employer's qualifying pension scheme without any active decision on their part.

- COBS 21.1 sets out the application of the rules. It states that the rules apply to insurers other than European Economic Area (EEA) insurers and to EEA insurers in the UK. It then lists a limited number of circumstances under which the rules do not apply.
- COBS 21.2 contains eight rules relating to the characteristics of assets that may be used as the basis of determining the benefits of unit-linked policies. Some of these rules put into place Consolidated Life Directive (CLD) requirements, in particular the need for accurate valuation in Article 23(3) and close matching of assets and liabilities in Articles 25(1) and (2). Other rules on the list reflect our view of how assets must be managed to ensure that linked policyholders are treated fairly.
- COBS 21.3 sets out the categories of assets that can be used to back linked benefits. This does not reflect the entire list of authorised assets in Article 23 of the CLD, as not all of them meet all of the rules in COBS 21.2.

The effect of Solvency II on COBS 21

COBS 21.1 Application

- 2.7 EEA insurers in the UK and insurers other than EEA insurers will continue to be subject to the revised rules in COBS 21. The rules in COBS 21 relate to the management of assets where it is the policyholder or beneficiary who bears the investment risk, not the insurer.
- 2.8 COBS 21.1.2R exempts specific categories of linked business. It is not clear that these exemptions in COBS 21.1.2R (1) to (6) serve any practical regulatory purpose. Subsequent reviews of the rules relating to linked business have led to the list of assets firms are able to use to calculate linked benefits becoming less restrictive. We therefore propose to delete them unless there is clear evidence to justify their retention.

Q1: Do you agree with our proposal to delete COBS 21.1.2R? If not, please provide details of how any existing policies might be adversely affected by the removal of the exemptions in COBS 21.1.2R.

COBS 21.2 Principles for firms engaged in linked long-term business.

- 2.9 The existing rules in COBS 21.2 overlap substantially with the provisions of Article 132 of Solvency II which is known as ‘the Prudent Person principle’. It is proposed that the rules transposing the Prudent Person principle will be set out in SOLPRU chapter 7³ as detailed in CP11/22. The rules in SOLPRU chapter 7 apply to all assets managed by insurers,

³ SOLPRU is the new prudential sourcebook replacing INSPRU and other elements of Handbook relating to insurance and reinsurance undertakings in the scope of Solvency II. Please refer to CP11/22 chapter 10 for further details of the transposition of Article 132 into SOLPRU.

regardless of whether they are held for solvency purposes or to back linked policies. The rules in SOLPRU chapter 7 will have the same effect for unit-linked insurance business as if they were in COBS 21.

- 2.10** We propose to delete those parts of COBS 21.2 which effectively duplicate rules in SOLPRU chapter 7. These are COBS 21.2.2R, 21.2.3R, 21.2.5R and 21.2.6R. For the avoidance of doubt we propose to introduce guidance to make it clear to firms that SOLPRU chapter 7 will apply with equal force to assets backing linked long-term policies.
- 2.11** However, the rules in SOLPRU chapter 7 will not apply to incoming EEA firms as the relevant Solvency II requirements will be imposed by their Home State regulator.
- 2.12** Other rules in COBS 21.2 relate to issues that are specific to the conduct regulation of linked business and so are not affected by the prudential requirements of Solvency II. These are COBS 21.2.1R, 21.2.4R, 21.2.7R, 21.2.8R and 21.2.9G and we propose to retain them. Annex 4 maps the existing requirements in COBS 21.2 to the proposed new structure of the rules in COBS 21 and SOLPRU.
- 2.13** COBS 21.2.1.R requires that a firm must ensure that the value of its permitted links are determined fairly and accurately. Article 75 of Solvency II refers more widely to valuation of assets and liabilities for prudential purposes, but COBS 21.2.1R applies to the valuation of policyholder benefits. In order to be able to calculate the value of policyholder benefits, a firm must be able to put a proper value on the assets being used to determine them. This applies both to the value used in the deemed allocation of new units to a policy and to the deemed cancellation of existing units. For the avoidance of doubt we will amend the wording of the current rule to make it clear that the revised rule is for the purposes of determining policyholder benefits fairly. We propose to amend the rule to clarify our requirement, reflected in COBS 21.2.4R, that this should be able to be done without materially changing the investment profile of the fund.
- 2.14** COBS 21.2.4R requires firms to notify linked policyholders of the risk profile of an investment strategy of a linked fund both at inception and before making any material change. This is to ensure policyholders understand the nature and the risks inherent in the assets backing their benefits when they take out their policies and they are told of important changes to it before they are made.
- 2.15** This rule is compatible with Article 185 of Solvency II, Information to policyholders, and so we propose to retain this rule, unchanged.
- 2.16** COBS 21.2.7R requires firms to consider the economic effect of its permitted links and permitted assets ahead of their legal form. This rule prevents firms from introducing assets that behave in a way completely at variance to eligible assets, simply because they have been able to construct a sufficiently ingenious legal argument to do so.
- 2.17** We do not see that this safeguard becomes any less important in relation to the revised list of assets detailed in paragraphs 2.36 to 2.64 below. We intend to retain this rule although it

will be moved to COBS 21.3 because it is only relevant to the assets to which that section applies. This proposal does not impose any extra requirements on firms in relation to the valuation of assets and liabilities.

- 2.18** COBS 21.2.8R and 21.2.9G require firms to notify the FSA as soon as they become aware of any breaches to the rules in COBS 21. This requirement was introduced as a change from the previous rules which were very rigid on this point and forced firms to seek waivers for even minor and unavoidable breaches. The guidance gives us the power to take a proportionate response to the nature and duration of the breach. We propose to retain this rule and guidance.

Q2: Do you agree with these proposals to amend COBS 21.2?

Governance

- 2.19** COBS 21.2.5R states that firms must ensure that their systems and controls and other resources are appropriate for the risks associated with their linked assets and linked liabilities. This duplicates SOLPRU 7.2.1R which says that a firm must only invest in assets and instruments, the risks of which can be properly identified, measured, monitored, managed, controlled and reported.
- 2.20** We also note that Article 44 of Solvency II states that firms must have in place effective risk management systems with 'strategies, processes and reporting procedures necessary to identify, measure, monitor and report, on a continuous basis, the risks, at an individual and at an aggregate level, to which they are or could be exposed, and their interdependencies'. It is clear that a part of having an effective risk management framework will be to have appropriate systems and governance controls in place to manage the risks associated with linked investments.
- 2.21** We have seen a number of examples of non compliance in relation to unit-linked business where funds have invested in non-permitted assets, their investment mixes have strayed from their stated mandates or their assets have not been managed in a way that complies with our rules – as in the case of indirect property holdings.
- 2.22** A common theme among those non compliance incidents has been that it was not clear who within the firms was responsible for ensuring compliance with our rules, be it in relation to ensuring assets qualify as permitted links, or that mandates are properly adhered to. We believe that these incidents have demonstrated some failures of governance by firms and that not all firms have appropriate systems and controls in place to comply with the requirements in Solvency II.
- 2.23** A number of firms that have had non compliance problems have since put in place governance structures to ensure that such incidents do not recur. Typically, they have a nominated person, usually a senior actuary, responsible for day-to-day pricing issues and

other technical issues such as fair allocation of tax between policyholders. This nominated person has a clear reporting line to a named individual on the firm's board. They have also formalised a unit-linked investment committee to ensure funds adhere to their mandates, do not contain non-permitted assets, to ensure there are regular reviews of marketing literature as appropriate and take decisions relating to fund closures and mergers. These committees usually have named chairpersons who again have clear reporting lines to their boards.

- 2.24** We also note that firms which have not experienced these kinds of problems to date often have broadly similar governance structures, although they do not necessarily have a named actuary responsible for pricing and other technical issues.
- 2.25** We are minded to bring forward proposals to enhance governance arrangements to reflect the requirements of Article 44 of Solvency II in relation to their unit-linked and index-linked business. However, we note that guidance for systems of governance is still being developed by EIOPA.⁴ We will bring forward our proposals in further consultation next year when we will have greater clarity over this guidance.
- 2.26** In doing so, we will need to consider the kinds of governance arrangements most appropriate for policies where the policyholder bears the direct investment risk. We see this as relevant to our wider work on product regulation.⁵

COBS 21.3 Assets and indices permitted as long-term policy benefit links

- 2.27** Solvency II requires that firms conform to a set of rules relating to how the assets they hold must be managed and how the associated risks are identified, measured, monitored, reported and controlled. These requirements are set out in Article 132 of Solvency II and apply to all of the assets held by firms, regardless of whether they are used for solvency purposes or to back policies where it is the policyholder who bears some or all of the investment risk.
- 2.28** In bringing in this new requirement, Article 132 abolishes the list of assets that life insurance firms can hold on their balance sheets and to which they can assign a value. This list is set out in Article 23 of the CLD. Consequently, firms will no longer be restricted to this list of assets when it comes to designing linked policies. They will be able to use other assets currently not on the list and, in some cases use assets such as derivatives for a wider range of purposes than previously possible.
- 2.29** The current rules in COBS 21.3 relating to the fair treatment of policyholders with linked long-term contracts are mostly based on the list of assets in Article 23 of the CLD. As a result COBS 21.3 needs to take account of the removal of the list of eligible assets and the new requirements in Solvency II.
- 2.30** However, while Solvency II removes the list of specified asset types, Article 133(3) of Solvency II allows Member State regulators to restrict the assets that can be used to

⁴ The European Insurance and Occupational Pensions Authority.

⁵ See DP 11/1, Product Intervention and FS 11/3, Product Intervention: Feedback on DP 11/1, published January and June 2011 respectively.

determine the benefits under policies taken out by retail policyholders and beneficiaries. Use of this power is subject to the condition that it must be no more restrictive than the list of assets in the UCITS Directive.⁶ The purpose of this power, set out in Article 133(3) of Solvency II, is to allow regulators to protect retail policyholders and beneficiaries from being exposed to assets that have inappropriately high levels of risk attached to them.

- 2.31** Individual policyholders who hold, for example personal pensions, whole-of-life plans, insurance bonds, and also members of DC occupational pension schemes invested in unit-linked life assurance policies bear all of the investment risk inherent in the assets backing their policy benefits. We consider restrictions on the assets that can be used to determine their benefits to be appropriate to meet our statutory objective of consumer protection.

Definition of institutional linked policyholders

- 2.32** COBS 21 defines institutional linked policyholders as trustees of defined benefit occupational pension schemes only. All other unit-linked policyholders are classed alike for the purposes of the rules.
- 2.33** As we explained in 2007⁷ when we set the definition of an institutional linked policyholder, we considered who bears the direct investment risk inherent in an asset. While the risks attached to particular assets can impact on the overall financial position of a defined benefit pension scheme, it does not necessarily have a direct effect on the benefits of any individual member. This is because the sponsoring employer is responsible for remedying any funding gap that may emerge as a result. Although they have similar governance arrangements in place by virtue of boards of trustees, members of defined contribution pension schemes do not have a similar buffer to protect them from the consequences of the risks inherent in a particular asset. Their benefits will be directly affected.
- 2.34** Institutional linked policyholders currently have a limited amount of greater investment freedom than all other policyholders in relation to exposure to Qualified Investor Schemes (QIS) and unregulated collective investment schemes (uCIS). However, the rules do not distinguish between the two categories of policyholder in the case of all other classes of asset and so the rest of the restrictions in COBS 21.3 currently apply to institutional linked policyholders. In future however, the specific requirements as to the particular types or classes of assets that can form permitted links in COBS 21.3 will only apply where the policyholder is a natural person bearing the direct investment risk. Insurers offering linked policies to policyholders who are not natural persons will not be subject to the requirements in COBS 21.3. This means these policies can be based on a far wider range of assets than the current rules allow, provided the insurer can properly manage the risks associated with those assets. We will therefore be deleting the reference that involves the definition of an institutional policyholder, as it currently stands. That reference appears in the definition of ‘permitted scheme interests’ in which, in future it will no longer be relevant. It is important to note that

⁶ COLL, Collective Investment Schemes, transposes the requirements of the UCITS Directive into our Handbook.

⁷ CP 07/7 and PS 07/17, *Permitted links for long term insurance business*, published in March and September 2007 respectively.

insurers offering linked policies to policyholders who are not natural persons – that is to say, customers who currently fall into the definition of institutional policyholder – will need to comply with the requirements of SOLPRU chapter 7 in relation to whether the assets selected can be monitored, managed, reported and controlled to meet the new requirements.

- 2.35** We continue to believe that, in the main, it is not appropriate for policyholders who are natural persons and beneficiaries who bear direct investment risk to be exposed to as potentially wide a range of assets as institutional policyholders. We propose to use the powers provided under Article 133 to maintain a list of specified asset types that can be used in these cases and to amend COBS 21.3 accordingly. We recognise that this approach may mean that some policyholders with the financial capability and means reasonably to be able to face these wider risks are precluded from doing so. We are not averse in principle to making the rules less restrictive in such cases, as we indicated in PS 07/17. However, since then we have received no practicable suggestions as to how we might do so.

Q3: The only policies not to be subject to the specific requirements of COBS 21.3 because the ultimate beneficiary does not bear the direct investment risk will be those effected on behalf of defined benefit occupational pension schemes. Do you agree?

The revised list of assets

- 2.36** The assets listed in COBS 21.3 are, with the two exceptions of indices based on non-financial assets and derivative use, wider than those available under the UCITS Directive. Unlike the UCITS Directive, COBS 21.3 does not contain prescriptive diversification requirements for each asset class or the detailed governance requirements that need to be in place for each UCITS fund. We do not propose to remove assets from COBS 21.3 in order to align it with the UCITS Directive. Instead, we propose to expand the list of assets to include, where appropriate, assets allowable in UCITS funds that are not currently allowed in COBS 21.3. We do not propose to introduce UCITS asset diversification requirements, except in the case of assets that are allowed under UCITS but not currently allowed by COBS 21.3. As discussed in paragraphs 2.19 to 2.26 above, governance issues, including whether it is appropriate to import UCITS standards of governance in such circumstances, will be consulted on next year.
- 2.37** All the assets we propose to include in the revised list in COBS 21.3 will be subject to the requirements of SOLPRU chapter 7 and the revised COBS 21.2. Below we examine each asset class in turn to ensure that the definitions currently in place are sufficient to encompass assets allowable under UCITS and where they are not, to propose amendments to COBS 21.3.

Approved securities

- 2.38 Both COBS 21 and COLL 5.2 allow the use of approved securities. We do not propose to make any changes.

Listed and unlisted securities

- 2.39 Listed securities are defined in COBS as any security that is admitted to an official list while unlisted securities in relation to permitted links, are defined as any non listed securities, provided that they are always realisable in the short term. Both definitions align with the requirements for UCITS set out in COLL 5.2. We note that investments in unlisted securities are limited to 10% of the value of any UCITS fund. We are not aware of any significant market failures in relation to unlisted securities held for such purposes so do not propose to introduce this limit for unlisted securities used to back linked benefits.

Q4: Do you agree with our proposal on approved securities and listed and unlisted securities?

Land and property

- 2.40 Land and property are not allowed as assets in UCITS funds. There are only two exceptions: first, UCITS funds can invest in derivatives based on property indices, and second, UCITS which are set up as investment companies with variable capital can own their own offices.
- 2.41 Land and property sit uncomfortably with the rules governing linked business in a number of important areas, e.g. their relative illiquidity and the intervals between valuations: this is not a new concern. The 1973 Scott Report⁸ which led to the first set of rules relating specifically to linked business, detailed a number of submissions that questioned whether property should be allowed at all.
- 2.42 COBS 21.3 allows land and property to be used to back linked benefits provided they are situated in a territory which has what we describe as ‘a properly functioning market’. We set out an indicative list of characteristics for such a market in the glossary definition of ‘permitted land and property’. Despite having the ability to restrict the list of permitted assets to UCITS investment powers, land and property constitute a major asset class within the unit-linked business and we believe that the current rule in COBS 21.3 is appropriate, including the ability for firms to back linked benefits with indirect property holdings.
- 2.43 Nevertheless, indirect investment in land and property has raised a number of concerns in relation to how unit-linked funds are managed. Indirect investment is allowed in linked funds provided it is held in a structure, or a series of structures, that do not pose a materially greater risk to linked policyholders than a direct holding and it is not geared in

⁸ *Linked Life Assurance. Report of the Committee on Property Bonds and Equity-Linked Life Assurance*, presented to the Secretary of State for Trade and Industry in April 1973.

excess of 10% of the gross asset value of the linked fund. Typically indirect holdings in land are made via uCIS which cannot account for more than 20% of the gross assets of a linked fund, can only invest in assets which are themselves permitted links and their prices must be published regularly.

- 2.44** A significant number of firms felt it necessary to invoke clauses in their policies allowing them to defer surrender and transfer requests from linked property funds during the recent financial crisis. This was done for two broad reasons.
- 2.45** First, firms were concerned that they might be forced into what would be a ‘fire sale’ of property assets where they were compelled to sell property at below what they considered to be a reasonable market price in order to meet the volume of surrenders and transfers. This raises the concern that firms’ property valuations may not always properly reflect the true value of their property holdings.
- 2.46** Second, firms with geared property holdings in uCIS found great difficulty in disposing of those particular assets. The gearing often made disposal difficult, as did the fact that in some cases the uCIS held one large property such as a retail park and had three or four other unit holders. In some cases, the only way to redeem units was to secure the permission of other unit-holders to wind up the fund and they were often unwilling to do so. As a result, some funds found it easier to dispose of direct property.
- 2.47** The consequence of this was that some linked funds found the value of their gross assets in uCIS exceeded 20% and their gearing exceeded 10% of the aggregate value of the linked fund. Both are clear breaches of COBS 21. Firms did not have appropriate regard to the principles in COBS 21.2, for example, that they must ensure that linked assets are capable of being realised in time to meet their obligations to linked policyholders.⁹ These failings reflected poor practice in terms of the selection and valuation of some assets. We draw firms’ attention to the requirement in SOLPRU chapter 7, which is that, ‘undertakings shall only invest in assets and instruments whose risks the undertaking concerned can properly identify, measure, monitor, manage, control and report’.
- 2.48** These breaches led us to take regulatory action against firms. We are not convinced that some firms would have been able to demonstrate that the above Solvency II requirements were discharged in relation to indirect property holdings during the financial crisis. We believe this demonstrated significant failures in governance by firms. As noted in paragraphs 2.19 to 2.26 above, we will bring forward proposals next year on governance.
- 2.49** Where property investments are made by member-directed funds we currently disapply the 10% limit on property gearing. This takes account of the fact that such funds, usually self-invested personal pensions where it is the policyholder or policyholders who select and direct the investments, will often hold their own premises which will be geared above 10%. We do not propose to change this exemption.

⁹ See section above at paragraphs 2.9 to 2.18 on how the principles in COBS 21.2 are changing.

- Q5:** Do you have any comments relating to our concerns over land and property? Do you agree with our proposal to maintain the rules relating to investments in land and property?

Loans

- 2.50** COBS 21.3 allows firms to use proceeds from commercial mortgages to back linked benefits. Firms are not allowed to use residential mortgages for these purposes. The effect of this rule in COBS 21.3, taken in combination with the ‘economic effect’ rule (COBS 21.2.7R) has been to protect unit-linked policyholders from the direct effect of the unravelling of residential mortgage-backed securities (RMBS) during the financial crisis. COBS 21 works on the basis of ‘look through’, which requires firms to ensure that where an instrument is based on the performance of underlying assets, those underlying assets are listed in COBS 21.3. As a result, RMBS, which proved to be so toxic, were not allowed to be used to back linked benefits.
- 2.51** We are aware of instances where firms did use RMBS to back linked benefits. These were clear breaches of our rules and resulted in regulatory interventions. We are concerned that they also demonstrated a failure in some firms’ governance.
- 2.52** Mortgages, commercial or residential, are not eligible investments for UCITS funds. However, we are aware that in some cases, RMBS are used in UCITS on the basis that they can be argued to meet the definition of a ‘money market instrument’. Taking into account the requirements of SOLPRU chapter 7 (see paragraph 2.47 on indirect property above) on the assets in which insurers can invest, we do not accept that the performance of RMBS during the crisis renders them eligible to be used in linked funds. We note that the Bank of England has similar concerns relating to complex financial instruments.¹⁰

Deposits and cash

- 2.53** Both COBS 21.2 and COLL 5.2 allow the use of deposits and cash. We do not propose to make any changes.

Money-market instrument

- 2.54** Money-market instruments are allowed as investments in UCITS but are not on the list of assets in COBS 21.3. It is arguable that money-market instruments cross over with a number of the assets listed in COBS 21.3, for example, approved securities. However, for the avoidance of doubt we propose to add a new category of money-market instruments based on our rules in COLL 5.2.7F to 5.2.7IG, amended to reflect that the assets are being held by an insurer rather than a CIS. In proposing this, we reiterate our view above that we do not consider that some RMBS behave in a way that renders them suitable as assets to be used to back linked benefits.

¹⁰ Bank of England *Financial Stability Report*, June 2011 Issue No 29. See pages 14 and 15.

Q6: Do you agree with our proposals on loans, deposits and cash and money-market instruments?

Collective investment schemes

- 2.55** Unit-linked funds make extensive use of CIS to back benefits. Currently UCITS, non-UCITS retail schemes (NURS) and recognised schemes, which we define as CIS authorised under sections 264, 270 and 272 of FSMA, can be used to back linked benefits without restriction. Up to 20% of the gross assets of a linked fund can be represented by Qualified Investor Schemes (QIS), their EEA equivalents and uCIS but they can only invest in assets that are on the list in COBS 21.3 and must publish their prices regularly.
- 2.56** UCITS can also be entirely invested in other UCITS, although there is a limit of 20% investment in any single scheme. Up to 30% of the value of a UCITS can be invested in total in non-UCITS collective investment schemes, which meet the requirements of COLL 5.2.14. QIS, uCIS and non-UCITS collective investment schemes which do not meet the requirements of COLL 5.2.14, do not constitute an eligible asset for a UCITS.
- 2.57** A UCITS is therefore more restricted in the way that it can invest in other CIS than a unit-linked insurance fund. We do not believe that there are any grounds for reducing the current access to CIS and we propose to maintain our current rules in this area.

Permitted units

- 2.58** It is common practice for linked benefits to be backed by assets held in an internal fund run either by the insurer issuing the policy or, via a reinsurance arrangement, by another insurer. The backing provided by the internal fund will be expressed as units. The term 'permitted units' has been coined in order to allow COBS 21.3 to express this. Investment in permitted units is not allowed under UCITS.
- 2.59** Where a firm offers policyholders the option of linking all or part of their benefits to the value of units of a fund run by another insurer, this has to be done via a reinsurance treaty between the two insurers. This raises some issues relating to the fair treatment of linked policyholders. These fall into two broad categories, both of which are addressed by COBS 21.3.3R and COBS 21.3.4G.
- 2.60** Firstly, under such an arrangement the policyholder is exposed to the creditworthiness of the reinsurer. In some cases, the ceding firm commits to taking on the risk of a default by the reinsurer; in other cases the firm allows the risk to sit with the policyholder. This latter case causes us concern, as the Financial Services Compensation Scheme (FSCS) does not cover these situations. It is in the policyholder's interest to be sure that the part of their policy ceded to the reinsurer is managed in a way that treats them fairly. This is particularly the case as we understand a number of firms are considering transferring this risk to new linked policyholders to reduce the cost of capital relating to reinsured business.

- 2.61** Second, where reinsurance firms are what is known as ‘pure reinsurers’ current directive provisions and FSA rules do not require such firms to maintain a ‘close matching’ position in relation to their linked assets. This means the firm is not required to maintain the one-to-one link between the policy benefits and the assets underlying them. Close matching is one of the corner stones of linked business. In its absence it is very important there is a robust governance process associated with the determination of the assets, which may be notional, on which the policy benefits are based.
- 2.62** To address these two issues COBS 21.3.3R requires firms to discharge their responsibilities to affected policyholders as if no reinsurance treaty is in place, supported by guidance on how this should be done: they should disclose any credit risk and suitably monitor the reinsured business so that they can continue to discharge their on-going responsibilities to policyholders. We propose to maintain this rule and guidance which reflect the requirement in articles 44 and 45 of Solvency II for firms to identify all risks for the purposes of their Own Risk and Solvency Assessment and have appropriate risk management systems to deal with those risks.

Q7: Do you agree with our proposals for collective investment schemes and permitted units?

Permitted stock lending and derivatives

- 2.63** EIOPA is still carrying out work on permitted stock lending and derivatives. We do not yet have sufficient clarity to consult on how these instruments will be treated in the revised COBS 21. We will bring forward our proposals in this area in our second consultation paper, which is scheduled for next year.

Index-linked benefits

- 2.64** Index-linked policies are backed by assets worth an estimated £24 billion. These policies typically use indices such as the Retail Prices Index or the FTSE 100 to revalue the face benefits provided by the policy. COBS 21.3 uses the definition of ‘approved index’ which allows the use of indices that meet certain criteria and are either based on assets that are themselves permitted links or national indices of retail or consumer prices. We propose to maintain this definition taking into account the wider range of assets that can be used as we align the rules with UCITS. We note that UCITS allows the use of indices based on some non-financial assets, such as commodities or precious metals. Where the use of such indices is possible under UCITS as set out in COLL 5.2 then it will also be possible to do so under an index-linked policy but only to the extent that the proportion of the policy benefits linked to such an index does not exceed the proportion of the assets of a UCITS that can be represented by that index. Moreover, where firms decide to link benefits to indices not currently permitted by COBS 21, they will need to demonstrate that they are complying with the prudent person investment principle as set out in SOLPRU chapter 7.

Q8: Do you agree with our proposals in relation to index-linked benefits?

Annex 1

List of questions

- Q1:** Do you agree with our proposal to delete COBS 21.1.2R? Please provide details of how any existing policies might be adversely affected by the removal of the exemptions in COBS 21.1.2R.
- Q2:** Do you agree with these proposals to amend COBS 21.2?
- Q3:** The only policies not to be subject to the specific requirements of COBS 21.3 because the ultimate beneficiary does not bear the direct investment risk will be those effected on behalf of defined benefit occupational pension schemes. Do you agree?
- Q4:** Do you agree with our proposal on approved securities and listed and unlisted securities?
- Q5:** Do you have any comments relating to our concerns over land and property? Do you agree with our proposal to maintain the rules relating to investments in land and property?
- Q6:** Do you agree with our proposals on loans, deposits and cash and money-market instruments?
- Q7:** Do you agree with our proposals for collective investment schemes and permitted units?

Q8: Do you agree with our proposals in relation to index-linked benefits?

Q9: Do you agree with our Diversity Impact Assessment?

Annex 2

Compatibility Statement

1. This section sets out our assessment of the compatibility of the proposals outlined in this CP with our general duties under section 2 of FSMA and with the regulatory objectives set out in sections 3 to 6.

Duty to act in a way that is compatible with the statutory objectives

2. Our proposals for amending the rules and guidance concerning unit and index-linked business are primarily designed to meet our consumer protection objective. They do not directly deal with our other statutory objectives which are: market confidence, financial stability and the reduction of financial crime.
3. The proposed changes implement requirements primarily in articles 132 and 133 of Solvency II which are designed to protect the interests of unit and index-linked policyholders. To the extent that the proposed changes are successful in safeguarding the interests of such policyholders, they will support our statutory objective of securing an appropriate degree of consumer protection.

Principles of good regulation

4. Section 2(3) of FSMA requires that in carrying out our general functions we have regard to the principles of good regulation.

The need to use our resources in the most efficient and economic way

5. The policy intention behind the proposed changes is to maintain an appropriate level of consumer protection under Solvency II, the proposals broadly mirror our existing rules, which are already subject to supervision. As a result, we do not consider the proposed changes will significantly impact on our resource requirements. Compliance with the proposed rules will be monitored in the course of our existing supervision and enforcement activities.

The role of management

6. One of the over-arching aims of Solvency II is to make management of insurance undertakings more accountable for risk management and controls. These proposals will facilitate this aim in the context of unit and index-linked business.

Proportionality

7. The changes proposed are required for us to comply with Solvency II. Where we have the freedom to do so, we propose to implement rules in a way that allows the rules and guidance to take account of the size and complexity of firms' business.

Innovation

8. Our proposals will allow for a widening in the classes of assets firms can use as the basis for the benefits payable under unit-linked policies. The range and nature of indices to which policy benefits are linked will also be extended. These changes will facilitate innovation in the range of unit and index-linked policies that are available.

International character and competition

9. We do not expect the proposals to have a material effect on these principles.

Regard to public awareness

10. We do not expect the proposals to have a material effect on this principle.

Compatibility with our duties under equalities legislation

11. The policy proposals described in this CP are designed to maintain the protection currently provided for unit and index-linked policyholders as a whole class of interested parties where Solvency II allows us to do so. We have conducted an assessment of the equality issues that arise in our proposals. Since they deal with the continuing protection of unit and index-linked policyholders as a whole we believe our proposals do not give rise to discrimination and that the proposals are of low relevance to the equality agenda. We would nevertheless welcome any comments respondents may have on any equality issues they believe arise from the proposals in this CP.

Q9: Do you agree with our Diversity Impact Assessment?

Annex 3

Cost benefit and market failure analysis

Introduction

1. When proposing new rules, or amendments to rules, we are obliged (under section 155 of FSMA) to publish a cost benefit analysis (CBA), unless we consider that the proposals will give rise to no costs or to an increase in costs of minimal significance.
2. This chapter concerns the CBA of proposed changes to COBS 21, primarily in relation to implementing articles 132 and 133 of Solvency II. These changes are:
 - removing COBS 21.1.2R, which lists a number of circumstances under which the COBS 21 rules do not apply;
 - removing some COBS 21.2 rules which duplicate rules proposed in SOLPRU Chapter 7;
 - changes to COBS 21.3, the list of assets, for institutional-linked policyholders; and
 - changes to COBS 21.3, the list of assets, for non-institutional linked policyholders.

Market failure analysis

3. For unit-linked funds, while the insurer is responsible for managing the fund and for making the investment decisions (under the investment mandate), it is policyholders who bear the investment risk, and who suffer direct financial detriment from inappropriate investment decisions.
4. The long-term insurance market is characterised by an imbalance of information where firms writing contracts of insurance know more about the risk and return profile of their funds than the policyholders.

5. In addition, there is a misalignment of incentives between firms and policyholders. While both insurer and policyholders benefit from positive investment return, insurers may have incentives to use discretion allowed under the contract to take inappropriately risky strategies. Their aim in doing so can be, for example, to boost their short-term investment performance record with a view to attracting more investment as their profit is correlated to the size of the assets under management. However, these inappropriately riskier investment strategies may well not be in the interests of policyholders.
6. The disclosure of information regarding the nature of the contract and how the insurer manages the unit-linked fund is unlikely, of itself, to be sufficient to mitigate this market failure. This is because retail consumers, in many cases, do not completely understand the investment risks of various assets.
7. Existing rules under COBS 21 aim to mitigate the impact of these market failures. And indeed, the rules which prohibit unit-linked funds investing in instruments such as residential mortgage-backed securities (RMBS) have helped prevent significant detriments to retail consumers.
8. However, in spite of our rules, RMBS were used in some unit-linked funds. In addition, some firms' investment mixes have strayed from their stated mandates. This non-compliance with our rules demonstrates the incentive for firms to take inappropriate risks.
9. The structure of and developments within the unit-linked market also create the potential for consumer detriment and are likely to amplify the extent of detriment arising from any market failure. Unit-linked funds are the investment vehicle of choice for defined contribution (DC) pension schemes. Any unsuitable investment decisions would have important consequences for the ability of policyholders or beneficiaries to fund their retirements or meet other financial needs. Some £524 billion is invested on behalf of individual pension customers or members of DC occupational pension schemes. A further £128 billion backs benefits taken out by individuals with investment-linked life assurance contracts.¹¹ The advent of auto-enrolment in pensions is likely to boost this amount.

Cost benefit analysis

Removing COBS 21.1.2R

10. There will be no CBA implication as these exemptions are no longer relevant. We are not aware any such business is still on any insurer's books.

¹¹ The balance represents policies taken out by corporate trustees of defined benefit occupational pension schemes.

Removing some COBS21.2 rules where they duplicate rules in SOLPRU Chapter 7

11. There will be no CBA implication as the COBS 21.2 rules proposed for removal are covered in the proposed SOLPRU Chapter 7.

Changes to COBS 21.3, the list of assets, for policyholders who are not natural persons

12. At present we define institutional policyholders as trustees of defined benefit occupational pension schemes only where the beneficiary, the scheme member, does not bear the direct investment risk. Policyholders who effect such contracts are not natural persons. Currently for such policies, insurers can only invest in the list of assets contained in the Consolidated Life Directive (CLD). There will no longer be a restricted list of assets for unit-linked policies taken out by policyholders who are not natural persons. Instead, insurers will be subject to Article 132, the prudent person principle (and all other relevant requirements of Solvency II).
13. Under the proposal, firms will benefit from having significantly greater freedom in the types of assets and instruments in which they can invest. A principal benefit will be the ability for greater diversification and for higher potential return, provided that they comply with the requirement in SOLPRU 7 which states that they can only invest in assets with risks that they can properly identify, measure, monitor, manage, control and report.
14. As the market failures identified above are mainly concerned with protecting retail consumers, that is to say, policyholders who are natural persons, we do not anticipate that the greater investment freedom insurers will have in relation to institutional policyholders will lead to material costs arising from detriment to policyholders. This is because the overall financial position of institutional-linked policyholders does not necessarily have a direct impact on the benefits of its individual members. The reason for this is individual members receive pre-agreed/fixed benefits while the sponsoring employer is responsible for remedying any funding shortfalls.
15. There are costs, such as updating investment prospectuses or setting up new funds associated with investing in assets that are not currently eligible under the permitted links rules. However, firms will only incur these additional costs if they decide to make use of the extra investment freedoms available.

Changes to COBS 21.3, the list of assets, for policyholders who are natural persons

16. The proposal to create a new category of permitted asset – a money-market instrument – and to change our interpretation of an approved index such that it is consistent with UCITS will have limited cost benefit implications.

17. The extension of COBS 21.3 to include a money-market instrument and indices allowed under UCITS should have the benefit of offering more flexibility to insurers and choice to policyholders. We do not believe there will be significant costs incurred, as this change is designed to align with UCITS, where there have been no issues around money-market instruments and other 'approved indices'.

Annex 4

Table mapping COBS 21.2 to SOLPRU and revised COBS 21

Ref	Current rules	Proposed new position
21.2.1R	To ensure that the values of its permitted links are determined fairly and accurately.	COBS 21.2.1R.
21.2.2R	To ensure that its linked assets: (1) are capable of being realised in time to meet its obligations to linked policyholders; and (2) are matched with its linked liabilities as required by the close matching rules.	SOLPRU 7.2.2R – 7.2.4R
21.2.3R	To ensure that there is no reasonably foreseeable risk that the aggregate value of any of its linked funds will become negative.	SOLPRU 7.2.2R – 7.2.4R
21.2.4R	To notify its linked policyholders of the risk profile and investment strategy for the linked fund: (1) at inception, and (2) before making any material changes.	COBS 21.2.4R
21.2.5R	To ensure that its systems and controls and other resources are appropriate for the risks associated with its linked assets and linked liabilities.	SOLPRU 7.2.1R (1)
21.2.6R	To ensure when selecting linked assets that there is no reasonably foreseeable risk of a conflict of interest with its linked policyholders. If a conflict does arise, the firm must take reasonable steps to ensure that the interests of the linked policyholders are safeguarded.	SOLPRU 7.2.2R

Solvency II and linked long-term insurance business

21.2.7R	A firm must consider the economic effect of its permitted links and permitted assets ahead of their legal form.	COBS 21.3.1R.(3)
21.2.8R	A firm must notify the FSA in writing as soon as it becomes aware of any failure to meet the requirements of this section.	COBS 21.2.8R
21.2.9G	In response to a written notification to the FSA described in 21.2.8.R, the FSA has regard to the exceptional or temporary nature of the circumstances and any other reasons for failure.	COBS 21.2.9G
21.3.3R	A firm that has entered into a reinsurance contract in respect of its linked long-term insurance business must nevertheless discharge its responsibilities under its linked long-term insurance contracts as if no reinsurance contract had been effected.	COBS 21.2.4AR

Appendix 1

Permitted links (amendment No 4)

PERMITTED LINKS (AMENDMENT NO 4) INSTRUMENT 2011

Powers exercised

- A. The Financial Services Authority makes this instrument in the exercise of the following powers and related provisions in or under the Financial Services and Markets Act 2000 (“the Act”):
- (1) section 138 (General rule-making power);
 - (2) section 141 (Insurance business rules);
 - (3) section 156 (General supplementary powers); and
 - (4) section 157(1) (Guidance).
- B. The rule-making powers listed above are specified for the purpose of section 153(2) (Rule-making instruments) of the Act.

Commencement

- C. This instrument comes into force on [*date*].

Amendments to the Handbook

- D. The Glossary of definitions is amended in accordance with Annex A to this instrument.
- E. The Conduct of Business sourcebook (COBS) is amended in accordance with Annex B to this instrument.

Citation

- F. This instrument may be cited as the Permitted Links (Amendment No 4) Instrument 2011.

By order of the Board
[*date*]

Annex A

Amendments to the Glossary

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

approved index in relation to *permitted links*:

- (a) ...
- (aa) a relevant indices meeting the requirements of COLL 5.2.33R; or

...

...

permitted scheme interests (a) ~~in respect of a firm's business with *institutional linked policyholders* only, any of the following:~~

- (i) ~~a *qualified investor scheme* or its *EEA* equivalent;~~
- (ii) ~~any *unregulated collective investment scheme* that invests only in *permitted links* and publishes its prices regularly;~~
- (iii) ~~any of the interests set out in (b)(i) to (b)(iv);~~

(b) in respect of a firm's business with *linked policyholders*, ~~other than those described in (a)~~, any of the following:

- (i) ...

Annex B

Amendments to the Conduct of Business sourcebook

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

21.1 Application

21.1.1 R ~~The rules in this section apply~~ Subject to COBS 21.1.1AR, this chapter applies on an ongoing basis to *linked long-term* contracts that are effected by:

...

21.1.1A R COBS 21.3 (Further rules for firms engaged in linked long-term insurance business) applies only in respect of *linked long-term contracts of insurance* where the investment risk is borne by a *policyholder* who is a natural person.

21.1.2 R ~~The rules in this section do not apply to:~~

- (1) ~~contracts that were effected before 1 July 1994, and under which *linked benefits* were permitted to be determined before that date;~~
- (2) ~~contracts effected by an *insurer* that are *linked long-term* contracts only because the policyholder is eligible to participate in any *established surplus*;~~
- (3) ~~contracts effected by an *EEA insurer* that are *linked long-term* contracts only because the *policyholder* is eligible to participate in an excess of assets representing the whole or a particular part of the *long-term insurance fund* over the liabilities, or a particular part of the liabilities, of the *insurer* as determined by the law of the *EEA state* in which the head office of the *insurer* is situated;~~
- (4) ~~[deleted]~~
- (5) ~~contracts effected before 30 June 1995, to the extent that they provide for benefits to be determined by reference to a *collective investment scheme* that was a *listed security* immediately before 1 July 1994; and~~
- (6) ~~contracts linked to *permitted units* that were effected before 1 February 1992, except to the extent that they relate to acts or omissions on or after that date. [deleted]~~

21.2 Principles Rules for firms engaged in linked long-term insurance business

21.2.1 R For the purposes of determining *policyholder* benefits A firm must ensure that the values of its *permitted links* are determined fairly and accurately.

- 21.2.1A R An insurer must not contract to provide benefits under linked long-term contracts of insurance that are determined wholly or partly, directly or indirectly, by reference to fluctuations in any index or wholly or partly by reference to the value of, or the income from, or fluctuations in the value of, property other than in accordance with the rules in this section.
- 21.2.1B G Insurers other than EEA insurers effecting linked long-term contracts of insurance are obliged to comply with the requirements on investments in the prudent person principle in SOLPRU 7.
- 21.2.2 R ~~A firm must ensure that its linked assets:~~
- (1) ~~are capable of being realised in time for it to meet its obligations to linked policyholders; and~~
- (2) ~~are matched with its linked liabilities as required by the close matching rules. [deleted]~~
- 21.2.3 R ~~A firm must ensure that there is no reasonably foreseeable risk that the aggregate value of any of its linked funds will become negative. [deleted]~~
- 21.2.4 R ...
- 21.2.4A R A firm that has entered into a reinsurance contract in respect of its linked long-term insurance business must nevertheless discharge its responsibilities under its linked long-term insurance contracts as if no reinsurance contract had been effected.
- 21.2.4B G In order to comply with the requirements of COBS 21.2.4AR a firm should:
- (1) disclose to policyholders the implications of any credit risk exposure they may face in relation to the solvency of the reinsurer; and
- (2) suitably monitor the way the reinsurer manages the business in order to discharge its continuing responsibilities to policyholders.
- 21.2.5 R ~~A firm must ensure that its systems and controls and other resources are appropriate for the risks associated with its linked assets and linked liabilities. [deleted]~~
- 21.2.6 R (1) ~~A firm must ensure when selecting linked assets that there is no reasonably foreseeable risk of a conflict of interest with its linked policyholders. [deleted]~~
- (2) ~~If a conflict does arise, the firm must take reasonable steps to ensure that the interests of the linked policyholders are safeguarded. [deleted]~~
- 21.2.7 R ~~In applying the rules in this section, a firm must consider the economic effect of its permitted links and linked assets ahead of their legal form. [deleted]~~

- 21.2.8 R *A firm* must notify the *FSA* in writing as soon as it becomes aware of any failure to meet the requirements of ~~this section~~ COBS 21 or SOLPRU 7 (Investments), as they apply in relation to linked long-term contracts of insurance.

...

21.3 **Further rules Rules for firms engaged in linked long-term insurance business**

- 21.3.1 R Where the rules in this section apply, an ~~An~~ *insurer* must not contract to provide benefits under *linked long-term contracts of insurance* that are determined:

- (1) ...
- (2) wholly or partly by reference to the value of, or the income from, or fluctuations in the value of, property other than any of the following:
- ...
- (h) ~~[deleted]~~ approved money market instruments meeting the requirements set out in COBS 21.3.6R to COBS 21.3.8R;
- ...
- (3) A firm must classify the types of property listed in (a) to (l) above according to their economic behaviour ahead of their legal form.

- 21.3.1A R The rules in this section apply to linked long-term contracts of insurance in respect of which the investment risk is borne by a policyholder who is a natural person.

...

- 21.3.3 R ~~A firm that has entered into a reinsurance contract in respect of its linked long-term insurance business must nevertheless discharge its responsibilities under its linked long-term insurance contracts as if no reinsurance contract had been effected. [deleted]~~

- 21.3.4 G ~~In order to comply with the requirements of COBS 21.3.3 R a firm should:~~
- (1) ~~disclose to policyholders the implications of any credit risk exposure they may face in relation to the solvency of the reinsurer; and~~
- (2) ~~suitably monitor the way the reinsurer manages the business in order to discharge its continuing responsibilities to policyholders. [deleted]~~

- 21.3.5 R (1) ~~Except in the case specified in (2), a firm which proposes to undertake linked long-term insurance business, which is linked to the~~

~~average earnings index and used for the purposes of orders made by the Department for Work and Pensions under section 148 of the Social Security Administration Act 1992, must notify the FSA in writing of its intention to do so in good time before effecting any such business for the first time, or if there is a material change in the volume of such business, and explain how the risks associated with this business will be safely managed. [deleted]~~

- (2) ~~These requirements do not apply in respect of liabilities for which a limited revaluation premium has been paid to the Department for Work and Pensions so that the liability for revaluation, while still linked to orders made under section 148 of the Social Security Administration Act 1992, is limited to 5%. [deleted]~~

21.3.6 R A money-market instrument shall be regarded as normally dealt in on the money market if it:

- (1) has a maturity at issuance of up to, and including, 397 days;
 (2) has a residual maturity of up to, and including, 397 days;
 (3) undergoes regular yield adjustments in line with money market conditions at least every 397 days; or
 (4) undergoes regular yield adjustments in line with money market conditions at least every 397 days.

21.3.7 R (1) A money-market instrument shall be regarded as liquid if it can be sold at limited cost in an adequately short timeframe.

- (2) A money-market instrument shall be regarded as having a value which can be accurately determined at any time if accurate and reliable valuations systems, which fulfil the following criteria, are available:

- (a) enabling the firm to calculate a net asset value in accordance with the value at which the instrument held in the portfolio could be exchanged between knowledgeable willing parties in an arm's length transaction; and
 (b) based either on market data or on valuation models, including systems based on amortised costs.

- (3) A money-market instrument that is normally dealt in on the money market and is admitted to, or dealt in, on an eligible market shall be presumed to be liquid and have a value which can be accurately determined at any time unless there is information available to the firm that would lead to a different determination.

21.3.8 R A firm should assess the liquidity of a money-market instrument in accordance with CESR's UCITS eligible assets guidelines with respect to

article 4(1) of the *UCITS eligible assets Directive*.

PUB REF: 002778

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