Feedback Statement

FS12/2

Financial Services Authority

Solvency II and linked long-term insurance business

Feedback on CP11/23

June 2012

FSA®

Financial Services Authority

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Annex 1: List of non-confidential respondents

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This Feedback Statement reports on the main issues arising from Consultation Paper 11/23: *Solvency II and linked long-term insurance business*.

Please address any comments or enquiries to:

Jason Yianni
Conduct Business Unit Policy
Financial Services Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

Telephone: 020 7066 4490
Email: cp11_23@fsa.gov.uk

Copies of this Feedback Statement 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

AVC	Additional Voluntary Contributions
COBS	Conduct of Business sourcebook (FSA Handbook)
COLL	Collective Investment Scheme sourcebook (FSA Handbook)
CIS	Collective investment scheme
CP	Consultation Paper
DB	Defined benefit
DC	Defined contribution
EU	European Union
FCA	Financial Conduct Authority
FSA	Financial Services 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)
MiFID	Markets in Financial Instruments Directive
RMBS	Residential Mortgage-Backed Securities
SOLPRU	The new FSA prudential sourcebook replacing INSPRU and elements of GENPRU relating to insurance and reinsurance undertakings

Solvency II	Directive 2009/138/EC
uCIS	Unregulated collective investment schemes
UCITS	Undertaking for Collective Investment in Transferable Securities Directive
QIS	Qualified Investor Scheme

1 Overview

Purpose

1.1 In Consultation Paper (CP) 11/23: *Solvency II and linked long-term insurance business*[1], we set out our proposals for changes to our rules and guidance on the operation of unit-linked and index-linked insurance policies, to ensure they comply with the requirements of Solvency II. These rules and guidance are found in the Conduct of Business sourcebook (COBS) 21, Permitted Links. This feedback statement sets out the responses we received on the CP.

Background

1.2 COBS 21 sets out the high-level rules firms must follow in managing their unit-linked business, as well as the types of assets they can use to back this business. The UK life sector currently manages assets of £783 billion, backing benefits under unit-linked policies.[2] A further £29 billion of assets relates to index-linked policies.

1.3 The overriding principle we have followed in reviewing these rules is to maintain our policy intention that, where the policyholder or beneficiary is a natural person and bears the direct investment or other risks in the assets used, we will maintain a restricted list of assets. This is to ensure they are protected from any inappropriate risks. In practice, this will mean retaining a restricted list of assets for individual policyholders with stakeholder pensions, personal pensions, endowments, insurance bonds and members of defined contribution (DC) occupational pension schemes. The introduction of automatic enrolment in October 2012, where many more consumers will join DC occupational pension schemes, will only make this principle more important.

1 www.fsa.gov.uk/static/pubs/cp/cp11_23.pdf
2 Source: SynThesys Life 2011

1.4 The changes we consulted on were:

- the application of the rules, including deleting redundant exemptions and removing overlapping prudential requirements covered in Solvency II;
- maintaining rules specifically related to conduct regulation;
- disapplying the current list of assets in COBS 21.3 and replacing it with SOLPRU 7 and revised COBS 21.2 for institutional policyholders (that is, where the policyholder is not a natural person who bears the investment risk); and
- revising the list of assets in COBS 21 where a policyholder or beneficiary is a natural person and directly bears the investment risk.

Who should read this paper?

1.5 This feedback statement should be read by all life insurance firms and friendly societies that write unit-linked business or have existing books of unit-linked and index-linked business. It should also be read by financial advisers. It may also be of interest to consumers with long-term polices and to consumer groups.

Responses

1.6 The consultation closed on 15 February 2012 and we received 20 responses. 17 of these were from firms and industry representatives in the life industry, two from advisers to the industry, and one from the Financial Services Consumer Panel.

1.7 Given the importance of this business in the UK life insurance sector, we are surprised that we had so few responses from those with an interest in this market.

1.8 This feedback statement summarises the comments we received and sets out our response to them. The final amended Handbook text will be included in a further Policy Statement on Solvency II, which will include all the Handbook changes consulted on as part of implementing the Directive. We expect to publish this in the near future. We are waiting to publish the final Handbook text so that firms are able to see the combined requirements as a whole rather than consider rule changes in isolation.

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Summary of responses to CP11/23

2.1 In this chapter, we report on the responses that we received to the questions in CP11/23, our views on those responses, and our policy decisions on how to proceed.

2.2 There was a wide range of responses to individual questions. There was, however, broad agreement with our general approach and no challenge to our assumptions in the cost benefit analysis. Some respondents made additional general comments unrelated to the questions asked. These are dealt with in Chapter 3.

Responses to individual questions from CP11/23

2.3 Our first proposal was to remove exemptions to specific categories of linked business in COBS 21.1.2R (1) to (6). These exemptions no longer serve a regulatory purpose and so we proposed deleting this rule.

> **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?*

2.4 Most respondents supported deletion of the exemptions. One respondent said they were unsure how this removal could apply to existing policies. Another echoed that there should remain provision for waivers, if issues were identified at a later date. Another respondent asked us to keep an open mind on these exemptions in case evidence arose that they are an integral part of a necessary level of consumer protection. They also requested that as a further safeguard the FSA could undertake a targeted review to ensure there is no consumer detriment from removing these exemptions.

Our response

We intend to remove the exemptions in COBS 21.1.2R as proposed. No respondent came forward with any evidence of issues that might result from this. Should any firm subsequently come across a case where issues might arise, they should contact us and we will consider the most appropriate way to deal with this concern.

2.5 Our second question related to changes to COBS 21.2. We proposed deleting the parts of COBS 21.2 that would otherwise effectively duplicate rules in SOLPRU Chapter 7, which will also apply to unit-linked business. These were COBS 21.2.2R, COBS 21.2.3R, COBS 21.2.5R and COBS 21.2.6R. We also proposed making it clear through guidance that SOLPRU 7 applies to assets backing linked business.[3]

2.6 We proposed that the remaining rules in COBS 21.2, which are conduct regulation, would be maintained or modified. The proposals were:

- to amend COBS 21.2.1R, which requires firms to value permitted links fairly and accurately, to make it clear that this rule relates to determining policyholder benefits fairly;
- to maintain COBS 21.2.4R, which requires firms to notify linked policyholders of the investment strategy and risk profile of a linked fund at inception and when any material change has been made;
- to retain the substance of COBS 21.2.7R, which requires firms to consider the economic effect of its permitted links ahead of their legal form, for the purposes of assessing whether those assets comply with the rules. This only applies where the policyholder or beneficiary is a natural person and bears the direct investment risk, so we proposed moving this rule into COBS 21.3; and
- to maintain COBS 21.2.8R, which requires firms to notify the FSA as soon as a firm becomes aware of a breach to the COBS 21 rules and its associated guidance in COBS 21.2.9G.

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

2.7 Most respondents supported our approach. One respondent argued that deleting the duplicate rules would add complexity, and suggested the rules should remain in COBS 21. A second questioned whether SOLPRU 7 rules would cover all insurer business, including non-EEA business.

3 See draft Handbook rules CP11/23 – COBS 21.2.1BG www.fsa.gov.uk/static/pubs/cp/cp11_23.pdf

2.8 Some respondents also questioned the impact of removing some of the rules that will be covered by SOLPRU 7. One respondent questioned how COBS 21.2.3R, which requires firms to ensure there is no foreseeable risk that the aggregate value of the linked fund will become negative, would be affected by proposed provisions in SOLPRU 7.2.2R to SOLPRU 7.2.4R.

2.9 Another respondent questioned whether requirements in SOLPRU 7 would directly replicate the close matching of assets and liabilities under COBS 21.2.2R.

2.10 Regarding the removal of COBS 21.2.6R, one respondent questioned whether the SOLPRU 7.2.2R rule on conflict of interest would be sufficient protection for policyholders.

2.11 There were also many views on the remaining rules. In relation to COBS 21.2.1R, one respondent argued that it is difficult to value some assets fairly and accurately due to fluctuations. This respondent suggested that the wording could be amended to align requirements with those in SOLPRU 7, with assets being 'fairly and realistically' valued.

2.12 One respondent suggested the industry misunderstood the criteria for a material change under COB 21.2.4R, especially in relation to collective investment schemes (CIS). They asked for further guidance on this, similar to that in place under COLL 4.3.5G. One respondent also argued that it may not be possible to notify policyholders ahead of material changes, as it may not be possible to anticipate all changes.

2.13 Some respondents questioned how the economic effect rule in COBS 21.2.7R applied to residential mortgage-backed securities (RMBS).

2.14 Many respondents, primarily firms, called for a materiality test to be added to COBS 21.2.8R. They proposed that firms should not have to inform the FSA where there is a breach of COBS 21 that is minor or transitory in nature.

Our response

We intend to make the rules as consulted on. However, as a variety of detailed points were made, we will also address them one by one.

Valuation requirement in COBS 21.2.1R – firms must be able to determine accurately policyholder benefits. If a firm is unable to value accurately and fairly the assets it uses to determine policy benefits, it questions their ability to meet their contractual obligations and treat their customers fairly.

Deleting rules and relying on SOLPRU 7 – where an insurer holds non-EEA business, the revised rules in COBS 21 and SOLPRU 7 will apply.

We are aware there are concerns with relying on SOLPRU 7. We will be considering the location and interaction of various requirements in the Handbook following the creation of the FCA and PRA, and will consider this question and other related issues as part of that review. Any such changes would be subject to future consultation.

On close matching requirements in COBS 21.2.2R, rules under SOLPRU 7.2.4R will require firms to closely match assets and liabilities. The draft rules in CP11/22 stated that "the firm must cover its technical provisions in respect of its linked long-term liabilities as closely as possible". To avoid doubt, this means firms will be required to closely match their unit-linked business. If a firm has trouble valuing assets fairly and accurately we would question whether the assets should be held in the first place, as this is a breach of our current rules and will remain so.

On current rules that the value of the linked fund cannot become negative, SOLPRU 7.2.2R-SOLPRU 7.2.4R taken together mean that the effect of this rule will continue, as firms will need to ensure assets and liabilities are closely matched. If a fund were to go negative, a firm would have breached the rules on close matching. Firms should already have proper controls in place to ensure this does not happen.

Further, on the deletion of COBS 21.2.6R, SOLPRU 7 implements stronger protections in relation to conflict of interest. SOLPRU 7.2.1R (3) states that "firms must…ensure that the investment of assets is made in the best interest of the policyholders". This is firmer than the current COBS 21.2.6R wording.

COB 21.2.4R and notifying policyholders in advance to changes – since its introduction in 2007, we have not received any indication that firms have had difficulty complying with this rule. Therefore, we intend to maintain our current policy.

Economic effect rules in COBS 21.2.7R and RMBS – we cover this issue in more detail under Question 6.

Notifications and a materiality test – we continue to believe that the rule as it stands remains appropriate. The change that was introduced in PS07/17 represented a significant relaxation of our previous approach. We believe it is necessary that firms inform us of all breaches, as these could indicate a wider problem in governance arrangements.

The rules do not require firms to sell assets immediately if they find they are in breach. For example, firms must inform the FSA as soon as they become aware of the breach, and set out their plan for disposing of the non-compliant assets, in an appropriate timeframe linked with the type of asset in question. No compelling evidence was presented for amending the current rule.

2.15 Our next question was on the definition of 'institutional linked policyholders'. Currently an institutional linked policyholder is defined as a trustee of a defined benefit (DB) occupational pension scheme and has a limited amount of greater investment freedom than other policyholders. We proposed removing the definition of an institutional linked policyholder. In future, a list of assets can only be maintained where the policyholder or beneficiary is a natural person and bears the direct investment risks and this can be no more restrictive than the UCITS Directive.[4]

> **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 affected on behalf of defined benefit occupational pension schemes. Do you agree?*

2.16 Respondents' views were divided on this issue. Some respondents, primarily firms, argued this was too narrow. Some suggested we remove the list of assets for policyholders that may meet the definition of a 'professional client' in COBS 3. Others suggested we could cross-refer to the current MiFID definitions of a professional investor. Many respondents also argued that greater freedom of investment should be extended to trustees of DC pension schemes, as they share characteristics similar to DB trustees. Some respondents questioned our legal interpretation of Solvency II in relation to DC trustees, as Article 133(3) refers to policyholders who are natural persons, not policyholders and beneficiaries.

2.17 Other respondents could not see a practical solution beyond what we had suggested and so supported our proposal, while others were in favour. In relation to DC pension trustees, one respondent strongly supported our conclusions and was seeking clarification that the list of assets in COBS 21.3 would also apply to additional voluntary contributions (AVC) to DB schemes where those contributions take the form of a DC benefit. One respondent asked for the definition of institutional linked policyholder to be retained.

2.18 In relation to the list of assets, one respondent suggested that, as Article 133(3) allows home regulators to apply rules as restrictive as UCITS, we could refer directly to the UCITS text. They said that where we intended to be less restrictive than UCITS we could then disapply those limitations.

4 See Article 133 (3) of Solvency II: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:335:0001:0155:en:PDF. The UCITS Directive can be found at: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0032:0096:EN:PDF

Our response

As set out at the start of this feedback statement, the principle underlying our approach to unit-linked business is that where the policyholder or beneficiary is a natural person and bears the direct investment risk, we will maintain a list of assets. This is intended to ensure consumers are properly protected from exposure to inappropriately risky assets.

We have not been convinced that there is a practical way, pressing need, or consumer demand, to extend the definition further.

We believe that Solvency II allows us to restrict the assets to which benefits can be linked in relation to DC pensions. It is the scheme members, not the trustees, who would suffer direct detriment where the assets prove to be inappropriate.

We also note that Recital 16 of Solvency II says: *'The main objective of insurance and reinsurance regulation and supervision is the adequate protection of policyholders and beneficiaries. The term beneficiary is intended to cover any natural or legal person who is entitled to a right under an insurance contract.'*

In relation to AVCs, where these are DC pensions, the list of specific assets will apply.

The general extension of investment freedom under Solvency II means maintaining a definition of institutional linked policyholder is no longer necessary. So we intend to remove the definition of institutional linked policyholder and maintain a list of assets for all other policyholders and beneficiaries. For these policyholders who are not natural persons, firms must comply with the requirements in SOLPRU 7 and the revised COBS 21.2 and any other relevant requirements in relation to their business.

2.19 We then moved on to the specific list of assets that would be applied to policyholders and beneficiaries who are natural persons and bear the direct investment risk. We proposed to maintain our existing approach to approved securities, listed and unlisted securities. Currently, these assets can be used without restriction.

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

2.20 Most respondents supported our proposal. One respondent asked for infrastructure projects to be included as permitted links. Only one respondent did not support our position on unlisted securities, stating: "We are not persuaded that the fact that there has been no significant failure in the past is a sufficiently compelling reason not to impose the UCITS 10% limit on unlisted securities." That respondent felt that if we did not impose the limit, we should monitor compliance closely to ensure firms are using unlisted securities that are realisable in the short term.

Our response

As stated in CP11/23, we are currently unaware of any significant issues in relation to unlisted securities. We intend to maintain our existing position and not introduce a limit for unlisted securities. We would, however, revisit this position if evidence of a problem emerged.

In relation to investment in infrastructure, the current rules do not necessarily prevent infrastructure investment if this is held in a form that is accepted, e.g. as an unlisted security that meets all the requirements of the COBS 21 rules.

2.21 The next question we asked was on our current rules on land and property. CP11/23 explored the restrictions on land and property within UCITS. It concluded that, while the powers under the Directive might give us the ability to prevent the use of land and property, these assets have been used for unit-linked business for many years and are a significant asset class for backing policyholder benefits. We proposed leaving the rules on land and property unaltered.

2.22 The CP did, however, raise concerns over the current use of land and property, especially in relation to governance and indirect property holdings. The financial crisis saw a number of firms with highly geared indirect property holdings finding that such holdings were more illiquid than direct property holdings. Some firms had difficulties disposing of these, and some directly held assets, for a fair price. To tackle this, some firms felt it necessary to invoke clauses to defer surrender and transfer requests in linked property funds.

2.23 Separately, where firms held indirect property in an unregulated collective investment schemes (uCIS), they often had to sell direct property holdings in a fund to meet obligations. This sale of direct property meant that some funds went over the 20% limit on indirect property holdings in an uCIS and the 10% gearing limit. This breached COBS 21 rules. We took regulatory action against these firms. These problems were not seen as an area where we needed to change rules, but were rather an area where we have concerns that some firms were not meeting existing rules due to the financial crisis. We saw this as a governance concern and one we said we would address in our later consultation on governance, to be published shortly.

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

2.24 Most respondents supported our approach to land and property, particularly our intention not to implement the UCITS restriction. However, some respondents said our views on firms' behaviour, in relation to land and property, were unduly harsh. Many of these respondents highlighted that the deferrals were intended to treat customers fairly and did not affect their ability to meet contractual obligations. These contractual obligations occur when policies reach set guarantee dates, their maturity dates or payments on death.

2.25 In terms of the illiquidity of the assets, some respondents suggested this was disclosed to policyholders. One respondent disputed that valuation contributed to redemption deferrals. Other respondents said direct property was valued independently and was subject to Royal Institute of Chartered Surveyors' requirements.

2.26 Other respondents agreed with our view, saying for example that the FSA's concerns are well-founded but the relatively illiquid nature of land and property means that this is an inherently difficult area.

2.27 In relation to indirect property holdings, some respondents wanted the 10% gearing level removed while others support maintaining the current level. One respondent also suggested the 20% uCIS restriction could be removed where there is no gearing.

Our response

We note views on our concerns over land and property are mixed. We continue to have concerns, particularly over the governance of land and property assets, and will cover this in our second consultation paper on implementing Solvency II.

We would remind firms of the implications of (b)(ii) in our Glossary definition of "*permitted land and property*". That applies the specific requirement that it must be:

"…held in a structure, or a series of structures, that do not pose a materially greater risk to *linked policyholders* than a direct holding…".

Our observations were that holdings of property uCIS could be both inherently more illiquid than direct holdings and incapable of being realised at anything close to the quoted unit price, which casts doubt on the valuation basis. From this evidence, we continue to believe that firms using these indirect holdings need to give careful consideration to whether these comply with the rule.

We intend to maintain our existing approach in relation to uCIS to avoid the potential for arbitrage. Retail access to uCIS is controlled by the marketing restriction in FSMA section 238, except in circumstances allowed by secondary legislation or FSA rules. In summary, uCIS are not allowed to be marketed to the general public. We are concerned that any change to COBS 21.3 would enable firms to use unit-linked business as a way to get around the marketing restriction, thereby creating regulatory arbitrage and the potential for consumer detriment. While we allow uCIS in linked funds, those funds have controls imposed on them through COBS 21: they can only invest in permitted links and must publish their prices regularly.

We also note wider concerns over the use of uCIS being inappropriately marketed to retail customers, but the issues raised in this feedback statement are different to the ones we intend to address in a future CP on uCIS.

On a wider governance point, one respondent suggested this should reflect a policyholder's reasonable expectations approach referred to in the *ABI Guide to Good Practice in Unit-Linked Funds*. The FSA's requirement is that firms treat customers fairly under Principle 6. Solvency II includes rules on governance that will supersede any guidance and our proposals in the forthcoming CP will reflect these requirements.

2.28 We then moved on to consider loans, deposits and a new category of assets – money-market instruments. In relation to loans, we clarified that only commercial mortgages are a permitted link. Residential mortgages and their collective, bundled or securitised equivalent are by implication not permitted.

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

2.29 Most respondents agreed with the overall policy proposals put forward for these assets, including the new category of money-market instruments. Many respondents were concerned that RMBS could not be used to back policyholder benefits under the rules. Many also highlighted concerns over our characterisation of this asset class, drawing our attention to the performance of UK and European Union (EU) RMBS.

2.30 In contrast, some of the other respondents said it should be made clear that no RMBS was qualifying. Others also wanted greater guidance on how RMBS links to the new money-market instrument definition.

Our response

We note the views on RMBS and reiterate that our current policy on use of residential mortgages which is that they are not permitted links, and so the use of RMBS, has not been altered.

COBS 21.2.7R requires firms to consider the economic effect of assets ahead of their legal form. We are aware that a number of firms hold RMBS investing in, for example, senior tranches of high quality UK residential mortgages. They are able to do this if they are satisfied that the economic behaviour of such senior tranches is more akin to permitted assets listed in COBS 21.3 than to the underlying mortgages (which in the case of such UK loans have themselves performed well). We are maintaining the effect of COBS 21.2.7R and so our policy on this issue is unchanged.

Where the policyholder does not bear the direct investment risk, the list of assets in COBS 21.3 will not apply. But firms will still have to comply with SOLPRU 7, revised COBS 21.2 and any other relevant requirements.

2.31 Our next question related to rules on the use of CIS and permitted units. Currently UCITS, non-UCITS retail schemes (NURS) and recognised schemes[5] can back benefits without restriction. Further, Qualified Investor Schemes (QIS), their EEA equivalent and uCIS can also be used, but these:

- can only represent up to 20% of a linked fund's gross assets;
- must be invested in assets on the list in COBS 21.3; and
- must publish their prices regularly.

2.32 Those who meet the current definition of an institutional linked policyholder (DB occupational pension trustees) can also have all of a unit-linked fund invested in a QIS, their EEA equivalent or uCIS.

2.33 We proposed maintaining the 20% limit for policyholders and beneficiaries who are natural persons and bear the direct investment risk.

2.34 In relation to permitted units, firms are currently able to link benefits to assets held in internal funds either run by the insurer issuing the policy or via another insurer through a reinsurance contract. We noted our concerns around the fair treatment of linked policyholders in the case of reinsurance. Firstly, these policyholders are exposed to the creditworthiness of the reinsurer. We noted that in the case of a default of the reinsurer, the policyholder would not be covered by the Financial Services Compensation Scheme (FSCS) and this should be disclosed to policyholders. Secondly, in the case of a pure reinsurer, there is no requirement for close matching of the linked assets. Both these issues resulted in COBS 21.3.3R requirements on firms to discharge their responsibilities to policyholders as though there was no reinsurance treaty in place and doing this by informing them of any credit risk exposure (COBS 21.3.4G). We proposed to maintain COBS 21.3.3R and COBS 21.3.4G.

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

2.35 Most respondents supported our proposals on CIS. A few respondents requested that greater access be given to QIS, where the QIS holds permitted links. One respondent particularly focused their response on greater freedom to use QIS to hold indirect property holdings.

2.36 Many respondents, primarily firms, raised issues around reinsurance. Most of these respondents asked for FSA clarification in COBS 21 that the policyholder can bear the credit risk of a reinsurance contract. Firms will often undertake reinsurance contracts to reduce their capital requirements and to offer wider investment choice. This does expose policyholders to the credit risk of the reinsurance company and many respondents argued that these policyholders have chosen to take on this risk by selecting a reinsured fund.

5 A recognised scheme is defined as a CIS authorised under sections 264, 270 and 272 of FSMA.

2.37 A number of respondents asked us to extend the scope of the FSCS to cover reinsured funds. Another respondent suggested that FSCS coverage should be reviewed for all scenarios where consumers were exposed to counterparty risk.

Our response

We have been aware of calls for an extension of the use of QIS in unit-linked funds for some time. No compelling case has been put forward for this extension, especially in relation to any possible benefit to consumers of allowing greater access when compared to exposure to permitted assets directly. On greater freedom of QIS for holding indirect property particularly, it would be perverse for us to do this when we have already noted our concerns about it. Access to QIS for policyholders who are not natural persons and to which COBS 21.3 does not apply will be widened in any case.

On reinsurance, it is for firms to make a commercial decision over who takes on the credit risk of the reinsurance firm. If the firm's intention is that the policyholder should bear this risk, this should be set out explicitly in the policy wording and customer facing material such as the key features document. Any reference to the extent to which FSCS cover applies to the policy must set out clearly instances where it does not. Without this requirement being met, it is not clear that the firm is treating the customer fairly.

If the policy is silent on reinsurance credit risk exposure, our approach continues to be that the risk falls on the firm. This would particularly be the case where documentation states "this policy is covered by the FSCS" without any further qualification. We do not accept that policyholders bearing such risk is inherent in the general nature of unit-linked business.

We are also not content for firms to seek to amend the terms and conditions of existing policies to shift, retrospectively, the risk from themselves and onto the policyholders without the policyholders' express agreement. Firms may have unilateral variation terms within their terms and conditions that may purport to allow firms to vary the contract without consent from policyholders. However, in our view, where firms have such unilateral variation terms, reliance on such terms to shift the risk from themselves and onto policyholders is likely to be contrary to good faith and would be likely to create a significant imbalance in the rights of the parties, to the detriment of consumers under the Unfair Terms in Consumer Contracts Regulations 1999. Therefore, we consider that firms would need to seek policyholders' express consent to introduce such a term.[6]

The FSCS can compensate consumers when authorised firms are unable, or likely to be unable, to satisfy claims against them. Before the FSCS can pay compensation,

6 See the Unfair Contract Terms Regulatory Guide (UNFCOG) for further information: http://fsahandbook.info/FSA/html/handbook/UNFCOG.

a number of conditions must be met.[7] In particular, the failed firm must owe the claimant a civil liability. For example, the firm may be in breach of its contract with the claimant and this has caused the claimant loss, or the firm may have given the claimant bad advice which has caused the claimant loss. This requirement for a civil liability applies across all sectors and has formed part of our rules which govern the operation of the FSCS since it was set up.

We believe the FSCS should continue to assess claims on the existing basis of a civil liability and should not provide additional protection in other cases, for example where a person suffers loss as a result of the failure of a counterparty or other third party. This would mean extending FSCS protection for the investment risk (including failure) associated with the performance of a person who had no legal connection with the claimant. It could also significantly increase the level of FSCS compensation costs which are met by other financial services firms.

The absence of a civil liability is the principal reason why the FSCS does not protect reinsurance contracts. We believe that the requirements in COBS 21 are the appropriate way to safeguard policyholders rather than extending FSCS protection. We also believe that the risk of consumer loss is further mitigated by the increasing of insurers' capital requirements.[8]

2.38 Our last question focused on index-linked business. We proposed to maintain the existing definition of index-linked business, taking into account the wider range of assets that can be used under UCITS on which benefits could be indexed. We further proposed that where indices are based on non-financial assets, such as commodities, the indices can be used in accordance with COLL rules, but subject to restriction. In these instances the proportion of the policy benefits linked to such an index must not exceed the proportion of the assets of a UCITS that can be represented by that index. Firms will also need to demonstrate that they are complying with the prudent person principle in SOLPRU 7 in relation to index-linked benefits.

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

2.39 Most respondents supported this approach. Only one respondent had concerns that our proposal was less restrictive than UCITS and asked for further guidance to be given on this issue.

7 Set out in the Compensation sourcebook (COMP) in the FSA Handbook.

8 See Solvency II: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:335:0001:0155:en:PDF.

Our response

We plan to maintain the existing definition of index-linked business with the additional requirements where indices are based on non-financial assets. We recognise that there may be some concerns over expanding into the use of indices based on non-financial assets. However, the introduction of UCITS diversification requirements where firms wish to go beyond the currently allowed indices is intended to deal with this concern.

2.40 Finally, we asked whether respondents agreed with the Diversity Impact Assessment included in the CP.

Q9: Do you agree with our Diversity Impact Assessment?

2.41 Few comments were made on this question. Those who did agreed with our assessment.

Our response

We thank those respondents who gave a view on the Diversity Impact Assessment.

3

Other issues raised

3.1 In addition to the answers above, respondents raised general points related to the rules. This section will consider these comments and respond to them.

3.2 Many respondents were anticipating the further consultation on governance of assets and proposals relating to derivatives.

Our response

Proposals on derivatives and governance will be included as part of a further consultation on implementing Solvency II, as noted earlier.

3.3 One respondent had concerns over time given to firms to make changes to funds to meet the new rules.

Our response

We understand the concerns created by the uncertainty around implementation of Solvency II. Where we are able to give certainty we will do so; this feedback statement is intended to aid clarity. Our work to implement Solvency II is part of a wider EU timetable. It is our intention that firms should be given as much time as possible to implement the rule changes.

3.4 Another respondent wanted clarity on how the rules apply to member-directed business, primarily Self-Invested Personal Pensions.

Our response

COBS 21 rules apply to member-directed funds as they do to other unit-linked business. We are maintaining the existing rules which exempt member-directed funds from the 10% gearing limit in relation to land and property. All other relevant requirements will continue to apply.

3.5 A few respondents identified that the definition of listed securities referred broadly to any security that is admitted to an official list in the EEA. This would appear to mean that securities listed in areas such as the US and Japan would be considered unlisted.

Our response

We recognise the limitation that the current wording implies. It is not our policy intention to restrict listed securities to the EEA only, and so will give this further consideration with a view to clarifying the position in the final Handbook rules.

Annex 1

List of non-confidential respondents

Actuarial Profession

Association of British Insurers

Association for Financial Markets

Association of Real Estate Funds

Aviva UK

Baillie Gifford Life

British Property Federation

Ernst & Young

Financial Services Consumer Panel

Friends Life

Institutional Investment Advisors

Investment & Life Assurance Group

Investment Management Association

Investment Property Forum

J.P. Morgan

Norton Rose

Prudential Assurance Company

Standard Life

Suffolk Life

Zurich Assurance

Two confidential responses were also received and two of the respondents above provided an additional confidential response.

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The Financial Services Authority
25 The North Colonnade Canary Wharf London E14 5HS
Telephone: +44 (0)20 7066 1000 Fax: +44 (0)20 7066 1099
Website: www.fsa.gov.uk

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