

FINANCIAL REINSURANCE INSTRUMENT 2006

Powers exercised

- A. The Financial Services Authority makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 (“the Act”):
- (1) section 138 (General rule-making power);
 - (2) section 150(2) (Actions for damages);
 - (3) section 156 (General supplementary powers);
 - (4) section 157(1) (Guidance); and
 - (5) section 340 (Appointment).
- 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 6 October 2006 and:
- (1) Annex B applies to insurers in relation to their respective financial years ending on and after 31 December 2006; and
 - (2) Annex C applies to the Society of Lloyd's and managing agents in relation to financial years ending on and after 31 December 2006.

Amendments to the Handbook

- D. The Integrated Prudential sourcebook (PRU) is amended in accordance with Annex A to this instrument.
- E. The Interim Prudential sourcebook for insurers (IPRU(INS)) is amended in accordance with Annex B to this instrument.
- F. The Lloyd's sourcebook (LLD) is amended in accordance with Annex C to this instrument.

Citation

- G. This instrument may be cited as the Financial Reinsurance Instrument 2006.

By order of the Board
28 September 2006

Annex A

Amendments to the Integrated Prudential sourcebook (PRU)

In PRU 7.1 (Insurance risk systems and controls) insert the following new paragraph after PRU 7.1.34G:

- 7.1.34A G A *firm* should analyse regularly the full effect of all its *reinsurance* agreements and other risk transfer agreements (both current and proposed), including any related agreements or side-letters, on both its current and potential future financial position, and ensure that:
- (1) all significant risks related to these agreements, and the residual risks borne by the *firm*, have been identified; and
 - (2) appropriate risk mitigation techniques have been applied to manage and control the risks.

Annex B

Amendments to the Interim Prudential sourcebook for insurers (IPRU(INS))

In this Annex underlining indicates new text. Where an entire section of text is inserted, the place where the change is made is indicated and the text is not underlined.

Chapter 9

FINANCIAL REPORTING

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Part I – Accounts and statements

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9.32 Additional information on general insurance business ceded

9.32A Additional information on financial reinsurance and financing arrangements: general insurers

9.32B Additional information on financial reinsurance and financing arrangements: guidance

...

Insert after rule 9.32 new rule 9.32A and accompanying guidance 9.32B as follows:

Additional information on financial reinsurance and financing arrangements: general insurers

- 9.32A
- (1) An *insurer* which carries on *general insurance business* must annex to the documents referred to in rules 9.12, 9.13 and 9.14, and relating to the *financial year in question*, a statement of the information required by this rule.
 - (2) This rule applies to any *contract of insurance* under which *general insurance business* has been *ceded* by the *insurer*, where -
 - (a) the value placed on future payments in respect of the contract in the *return* for the *financial year in question* is not commensurate with the economic value provided by that contract, after taking account of the level of risk transferred; or
 - (b) there are terms or foreseeable contingencies (other than the insured event) that have the potential to affect materially the value placed on the contract in the *insurer's* balance sheet at, or any time after, the end of the *financial year in question*.
 - (3) In determining whether a *contract of insurance* meets one or both of the

- conditions in (2), the *insurer* must -
- (a) treat as part of a contract any agreements, correspondence (including side-letters) or understandings that amend or modify, or purport to amend or modify, the contract or its operation; and
 - (b) consider whether the contract meets the condition in (2)(a) when considered together with one or more other *contracts of insurance* entered into between:
 - (i) the *insurer* and the *reinsurer* under the first contract; or
 - (ii) the *insurer* and any other *person*, where it could reasonably be predicted, at the time the most recent contract was entered into, that the contracts when considered together would meet the condition in (2)(a).
- (4) Subject to (9), for each *contract of insurance* to which this rule applies the statement must contain the following information -
- (a) the *financial year* of the *return* in which the contract was first reported in the *return*;
 - (b) the financial effect of the contract on the *insurer's capital resources* as shown in line 13 of **Form 1** of the *return* for the *financial year in question*;
 - (c) the amount of any undischarged obligation of the *insurer* under the contract and a brief description of the conditions for the discharge of such obligation; and
 - (d) how any undischarged obligations, including any contingent obligations, have been taken into account in determining the *insurer's capital resources*.
- (5) The statement must include a general description of how the *insurer* makes the financial assessment that enables it to determine whether a contract satisfies the condition in (2)(a), even if there are no contracts in respect of which information is required by (4).
- (6) This rule also applies to any **financing arrangement**, which for the purpose of this rule means any contract, other than a *contract of insurance*, that has been entered into by the *insurer*, in respect of *contracts of insurance* written by the *insurer*, which has the effect of increasing the *capital resources* of the *insurer* in line 13 of **Form 1**, and which includes terms for –
- (a) the transfer of assets to the *insurer*, the creation of a *debt* to the *insurer* or the transfer from the *insurer* to another party of liabilities to *policyholders* (or any combination of these); and
 - (b) either an obligation for the *insurer* to return (with or without interest)

some or all of such assets, a provision for the diminution of such *debt* or a provision for the recapture of such liabilities, in each case, in specified circumstances.

- (7) In determining whether a contract falls within the definition of 'financing arrangement' in (6), the *insurer* must -
- (a) treat as part of a contract any agreements, correspondence (including side-letters) or understandings that amend or modify, or purport to amend or modify, the contract or its operation; and
 - (b) consider whether the contract meets the conditions in (6) when considered together with one or more other contracts entered into between:
 - (i) the *insurer* and the *counterparty* under the first contract; or
 - (ii) the *insurer* and any other *person*, where it could reasonably be predicted, at the time the most recent contract was entered into, that the contracts when considered together would meet the conditions in (6).
- (8) Subject to (9), for each 'financing arrangement' entered into by the *insurer* the statement must contain the following information -
- (a) the *financial year* of the *return* in which the 'financing arrangement' was first reported in the *return*;
 - (b) the financial effect of the 'financing arrangement' on the *insurer's capital resources* as shown in line 13 of **Form 1** of the *return* for the *financial year in question*;
 - (c) the amount of any undischarged obligation of the *insurer* under the 'financing arrangement' and a brief description of the conditions for the discharge of such obligation; and
 - (d) how any undischarged obligations, including any contingent obligations, have been taken into account in determining the *insurer's capital resources*.
- (9) No information need be supplied pursuant to (4) or (8) in respect of a *contract of insurance* or 'financing arrangement' if, when it is considered in aggregate with all such contracts with the same *reinsurer* or *counterparty* or any other *person* with whom the *insurer* has entered into a contract in the circumstances described in (3)(b)(ii) or, as the case may be, (7)(b)(ii) -
- (a) A is less than 1% of B in the *return* for the *financial year in question*; and
 - (b) the *insurer* expects A to remain less than 1% of B for the foreseeable future;

where:

- (i) A is the financial effect on the *insurer's capital resources* as a result of the existence of the contract(s); and
 - (ii) B is the *insurer's total technical provisions*.
- (10) Where the statement required by (1) includes information about a *contract of insurance* in respect of which information has been included in the statement required by rule 9.32 relating to the *financial year in question*, the *insurer* must include in the statement under (1) a cross-reference to that other information.

Additional information on financial reinsurance and financing arrangements: guidance

- 9.32B
- (1) In line with normal practice, an *insurer* may take account of an appropriate risk margin to reflect the nature and level of risk transferred, including any uncertainty in the amount and timing of future payments, when assessing the economic value of the transaction at the end of the *financial year in question* in order to see whether the condition in rule 9.32A(2)(a) is met. In addition, an *insurer* would be expected to take account of any credit or legal risk associated with the transaction when assessing its economic value.
 - (2) For most *proportional reinsurance treaties* and most standard *non-proportional reinsurance treaties*, such as contracts providing excess-of-loss cover, which include a significant transfer of risk to the *reinsurer* and do not contain any of the features described in (5) below, it is likely that the *insurer* will be able to determine that the contracts do not meet the condition in rule 9.32A(2)(a) without making a detailed calculation. The approach taken to the assessment made for the purpose of rule 9.32A(2)(a) should, however, still be described in the statement provided as required by rule 9.32A(5).
 - (3) When considering whether there are foreseeable contingencies, other than the insured event, that may affect the contract's given value, the *insurer* should consider the normal commercial uncertainties about the size of the *claim* that may ultimately be payable (for example, the outcome of any possible court action) to be part of the insured event. These normal commercial uncertainties would not then trigger any disclosure requirement under rule 9.32A.
 - (4) It is likely that one or both of the conditions in rule 9.32A(2) will be satisfied if the *contract of insurance* contains features that have the effect of materially limiting the size of the difference between -
 - (a) the extent of the indemnity cover provided by the contract and by any related or potentially related contracts, and
 - (b) the *premiums* payable under those contracts,

relative to the size of the *premiums* payable under those contracts.

- (5) Some characteristic features which the *insurer* should consider carefully in relation to a *contract of insurance* before deciding whether one or both of the conditions in rule 9.32A(2) are satisfied with respect to a particular contract include (but are not limited to) the following -
- (a) sliding scale fees, retrospectively rated *premiums* and profit-sharing formulae which adjust cash flows between the *insurer* and the *reinsurer* based on loss experience (for example, increasing payments from the *insurer* as losses increase and decreasing payments as losses decrease, subject to maximum and minimum limits);
 - (b) provision for an *experience account* or arrangements having similar effect, including arrangements which recognise an assumed rate of investment return;
 - (c) provision for, or a contingent obligation on, the *insurer* to make payments to the *reinsurer* or to any other *person*, where the payments -
 - (i) depend upon the loss experience of *general insurance business* that has been or may be carried on by the *insurer*; and
 - (ii) are not simply reinstatement *premiums*;
 - (d) provision for termination or commutation of the contract at the sole discretion of the *reinsurer*, when there is a positive balance of money due from the *reinsurer*;
 - (e) a provision for, or a contingent obligation on, the *insurer* to make payments to the *reinsurer* or to any other *person*, where the payments are in respect of business carried on in a period outside of the term of the contract;
 - (f) the contract includes a term requiring the *insurer* to enter into a further contract if the loss experience of the business subject to the contract attains a specified level;
 - (g) the term of the contract exceeds, or may exceed, 12 months, and the *premium* or amount of indemnity payable under the contract in subsequent years may be affected by the loss experience of earlier years;
 - (h) dual triggers which require the occurrence of both -
 - (i) an insurable event; and
 - (ii) a change in a separate variable specified in the contract;

in order to trigger payment of a benefit/*claim*;

- (i) amounts payable under the contract could affect, or depend on, other contracts or agreements entered into by the *insurer*, or a *person connected* with the *insurer*, except where -
 - (i) that effect or dependence is clear from the description of that other contract or agreement given by the *insurer*; or
 - (ii) that effect or dependence arises solely as part of the normal market mechanism for the pricing of a risk; and
 - (j) terms that defer payment of *claims* -
 - (i) for a period of more than 12 months after the amount payable under the contract has been agreed; or
 - (ii) until some specified date that is more than 12 months after the end of the term of the contract.
- (6) For the purpose of rule 9.32A(4), (8) and (9), the 'financial effect' of the transaction (that is, the contract or 'financing arrangement') on the *insurer's capital resources* should normally be regarded as the sum of (a) the value placed on the transaction in the *return* for the *financial year in question* plus (b) the net sum of all receipts less payments made in respect of the transaction since the transaction was first reported in the *return*.

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Chapter 11

DEFINITIONS

PART 1

DEFINITIONS

Insert the following new definition in the appropriate alphabetical place:

<i>experience account</i>	<p>an account (whether real or notional) established under a <i>contract of insurance</i> where:</p> <ul style="list-style-type: none">(a) <i>premiums</i> payable or paid, or amounts related to <i>premiums</i> payable or paid, under the contract are credited to the account;(b) <i>claims</i> payable or paid or incurred, or amounts related to <i>claims</i> payable or paid or incurred, under the contract are deducted from the account; and
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	<p>(c) either:</p> <ul style="list-style-type: none">(i) some part of the amount held in the account is paid out on expiry or termination of the contract in accordance with rights specified in the contract; or(ii) the amount held in the account affects the amount payable under the contract.
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Annex C

Amendments to the Lloyd's sourcebook (LLD)

In this Annex underlining indicates new text and striking through indicates deleted text. Where an entire section of text is inserted, the place where the change is made is indicated and the text is not underlined.

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- 15.2.4 R With the exception of the statements required to be annexed to the *Lloyd's Return* by LLD 15.3.6R, the ~~The~~ *Lloyd's Return* must be examined and reported on by the auditors appointed to audit the affairs of the *Society*.

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Insert after LLD 15.3.5R new rules LLD 15.3.6R and LLD 15.3.7R as follows:

- 15.3.6 R The *Society* must annex to the *Lloyd's Return* a copy of each statement completed by a *managing agent* under LLD 15.13.9R.
- 15.3.7 R For the purposes of the *Lloyd's Return* and LLD 15.3.6R, the *Society* must, for each statement annexed, identify the *syndicate* to which the *contract of insurance* or 'financing arrangement' relates.

...

Insert after LLD 15.13.6R new guidance paragraph LLD 15.13.6AG as follows:

- 15.13.6 G The statements required to be annexed to the return by LLD 15.13.9R should
A not be included in the audit under LLD 15.13.6R.

...

Insert after LLD 15.13.8R new rule LLD 15.13.9R as follows:

- 15.13.9 R A *managing agent* must annex to each return which it prepares under LLD 15.13.1R a statement of the information required by *IPRU(INS) rule 9.32A*, as if in that *rule* references to:

- (1) '*insurer*' were to the *members* carrying on *insurance business* through the relevant *syndicate*;
- (2) the '*return*' were to the return required to be prepared by it in respect of the business carried on through the relevant *syndicate* under *LLD* 15.13.1R;
- (3) the '*insurer's* balance sheet' were to the *syndicate* balance sheet;
- (4) the '*insurer's capital resources*' were to the *capital resources* managed by or at the direction of the *managing agent* in respect of the *insurance business* carried on through the relevant *syndicate*; and
- (5) the '*insurer's total technical provisions*' were to the *technical provisions* in respect of the *insurance business* carried on through the relevant *syndicate*.