

# **The Requirement for Close Matching of Linked Liabilities**

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## ***Introduction to Revised Issue – February 2006***

This note was originally issued in May 2004. At that time, the FSA's proposals for changes to its rules book were still in consultation, in CP 97a. Those changes have now been implemented in its Prudential Sourcebook and therefore I have changed the note to bring the references and the interpretation of those references up-to-date.

For the avoidance of doubt, since the question has arisen following the original issue of this note, I should emphasise at the outset the fact that close-matching arises from insurance legislation. This means that the rules on close-matching do not apply to non-insurer defendants; including self-insured defendants, and government departments and bodies funded on a pay-as-you-go basis. Non-insurer defendants may as a matter of sound practice and governance wish to apply the concepts of close-matching to the assets held for periodical payment liabilities, but where the payments are met on a pay-as-you-go basis, the concept of close-matching has no meaning.

My thanks are given to those who made valuable comments on the first issue of the note.



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## ***Preamble***

This note explains what is meant by the term ‘close matching’ and identifies the business to which it applies. The explanations are cross-referenced to the legal and regulatory requirements and sufficient detail of the legislative history is given to enable the current position to be understood. The relevant texts of the legislation, extracts of which are referred to in the text, are relegated to appendices.

Love them or loath them, acronyms litter legislation and regulation. For ease of reference and to aid understanding, those referred to in this note are listed here.

|            |  |
|------------|--|
| CP 97      | The FSA’s Consultation Paper 97, consulting on the form and content of the proposed Integrated Prudential Sourcebook, issued June 2001.<br><br>CP97 contains two annexes: a third (Annex C) containing draft rules was issued as a separate document and is known as CP97a |
| CP 97a     | Annex C to CP97, containing draft rules for the proposed Integrated Prudential Sourcebook  |
| FSA        | The Financial Services Authority   |
| ICA 82     | The Insurance Companies Act 1982 (1982 Chapter 50)   |
| IPRU (INS) | The FSA’s Interim Prudential Sourcebook for Insurers, issued 21 June 2001  |
| PRU        | The FSA’s Integrated Prudential Sourcebook   |
| RPI        | Retail Prices Index  |
| SI         | Statutory Instrument   |



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## ***Executive Summary***

In this note I conclude as follows:

1. The requirements for close matching arise in an EU Directive and there is, therefore, no scope for the UK government to amend or relax its requirements to facilitate any other intentions it may have with regard to periodic payments.

2. The close matching requirements do not currently apply to general funds. There is therefore no current requirement to close-match RPI-linked periodic payments.

*... which means that there is regulatory arbitrage between life funds and general fund.*

3. Close matching applies to contracts in existence at the date the regulations first apply to the fund, as well as to new contracts.

*... which means that if steps are taken to correct the imbalance, any periodic payments in place at that time will then have to be close matched with appropriate assets.*

4. If the insurer has incurred liabilities that cannot be exactly matched, it should try to match assets that at least cover the liabilities.

*... which means that despite there being no index-linked government stocks with redemption dates after 2055, there is no legal bar to issuing index-linked liabilities with potentially longer payment dates providing that the firm then seeks to acquire assets that at least cover the index.*



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5. A defendant that is unable to self-fund periodic payments on the ground that it does not satisfy the 'security' test introduced by the Courts Act 2003, may be unable to meet the full index-linking requirements that the court may look to impose, by purchasing a structured settlement annuity.

*... which means that the intentions of the Courts Act 2003 may be frustrated for these defendants.*

6. An earnings-linked structured settlement annuity is not permitted but earnings-linked periodic payments would breach no regulations.

*... which means that an earning-linked order, should one be made, can be met by periodic payments and cannot be transferred to a life company to be met by an annuity.*

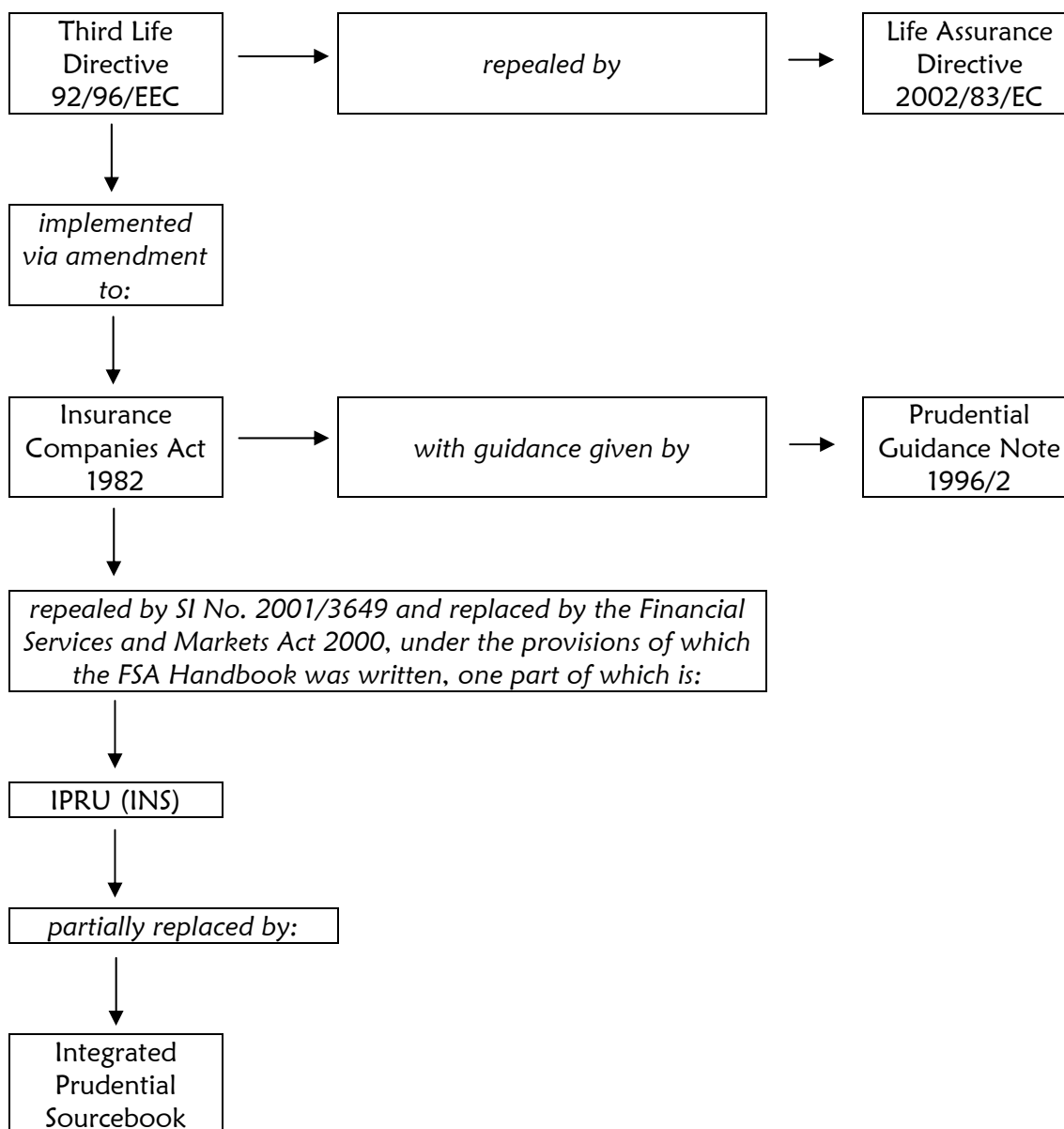
7. Prior to the latest rules changes, the requirement for close-matching was conceptual with specific direction on acceptable assets being given in guidance. The FSA's rules now reverse that process, giving in rules a list of acceptable assets with guidance being given only on departures from the list.

*... which means that there is reduced scope for discretion.*



## ***Following the requirement through legislation***

In graphical form, the trail of legislation and regulation is as follows:





The original requirement for close matching arose in a European Council Directive, known as 'The Third Life Directive, 92/96/EEC'. The requirements of this Directive were required to be adopted by member states no later than 31 December 1993 and brought into force no later than 1 July 1994 (Article 51). Note the reference to 'Life': the directive does not apply to general insurance business.

The text of the requirement in 92/96/EEC is given in Appendix 1. That part which is directly relevant to index linked liabilities is part 2, which states:

“Where the benefits provided by a contract are directly linked to ... some other reference value ... the technical provisions ... must be represented as closely as possible ... by assets of appropriate security and marketability which correspond as closely as possible with those on which the particular reference value is based.”

In passing, we can consider whether relief might lie in the fact that 92/96/EEC is no longer in force. However, the Directive that replaced it, 2002/83/EC, has wording in Title III, Chapter 2, Article 25, which is to all intents and purposes identical<sup>1</sup>. The requirement therefore continues and must remain with at least equivalent strength, in UK legislation.

We then follow the implementation of this requirement through its various UK enactments, repeals, and regulations.

- The UK government initially enacted the requirement by way of an amendment to ICA 82<sup>2</sup>, the amended wording of which is reproduced in Appendix 2.

It can be seen that the wording in 92/96/EEC section 2 quoted above is enacted with minor differences in ICA 82 section 35A (2) (b).

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<sup>1</sup> References to other Articles in the Directive were changed to reflect the appropriate numbering, and one grammatical error was corrected.

<sup>2</sup> By way of Regulation 17 of The Insurance Companies (Third Insurance Directives) Regulations 1994 and as amended by Regulation 6(1)-(3) of The Insurance Companies (Amendment) Regulations 1994.





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- PRU (extract in Appendix 4 of this note) repeats the wording. Guidance, previously given in Prudential Guidance Note 1996/2 (not reproduced in this note), and then in Guidance Note 4.4 of Volume 3 of IPRU (INS) (also not reproduced in this note) no longer exists except to the extent that it lies within PRU 4.2.59, 4.2.60, and 4.2.61.

It should be noted that the rules and guidance apply to all regulated firms and that no differentiation is made between long-term insurance business and general insurance business. I will discuss below how the text should be interpreted.



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## ***Commentary***

Having followed the trail of legislation and regulation, I will give my interpretation of the requirements.

### ***1. Does close matching apply to general business as well as long-term business?***

PRU 4.2.57 R and PRU 4.2.58 R (see Appendix 4) apply (and only apply) the close matching requirement to property-linked and index-linked liabilities. Property-linked liabilities are not relevant to this note. By referring to the FSA's Glossary (relevant definitions are reproduced in Appendix 4) we can see that the FSA defines 'index-linked liabilities' as being,

'insurance liabilities in respect of index-linked benefits.'

and further defines index-linked benefits as:

'benefits:

- (a) provided for under a linked long-term contract of insurance; and
- (b) determined by reference to an index of the value of property of any description (whether specified in the contract or not).'

A linked long-term contract of insurance is defined carefully, if somewhat wordily, as life insurance and not general insurance.

Therefore, as index-linked periodic payments do not fall into the definition of life insurance, they are accordingly not within the close-matching requirements.

- a. Consequently there is no current requirement to close match index-linked periodic payments.**
- b. There remains a lack of equivalence between life (structured settlement annuities) and general (periodic payments) that the FSA may be required to address in order to avoid regulatory arbitrage.**



**2. Does close matching apply to existing contracts as well as to new contracts?**

The wording of PRU applies to ‘... its index-linked liabilities’ and those in turn are benefits ‘... provided for ...’ and I interpret this to apply to in-force business, not simply to new business.

**I do not believe that there can be any relief in respect of business in force prior to the coming into effect, or the applicability, of the rule.**

**3. How close is ‘close’? What about the ‘2035’ question?**

Whilst reference is still made to the ‘2035’ question, we should perhaps now refer to the ‘2055’ question following the issue of 1¼% IL Treasury 2055 in September 2005. The principle remains: there is a date beyond which, if no new index-linked gilts are issued, there will be no ILGS asset to match continuing index-linked liabilities.

There are several aspects to the closeness of matching which I will address in turn.

PRU 4.2.58 R states that a firm must cover its index-linked liabilities with one or more of a mix of specified assets.

Note that whilst PRU 4.2.58 in (1)(b) repeats the wording originally appearing in the Third Life Directive it also enshrines in a rule the permissible extended choice of matching assets. This had previously been given as guidance<sup>3</sup>.

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<sup>3</sup> “The letter R is used to indicate general rules made under section 138 of the Act, specialised rules made under sections 140 to 147, listing rules made under section 73A and rules made under other powers. It is not used for evidential provisions ... Most of the rules in the Handbook create binding obligations on firms. If a firm contravenes such a rule, it may be subject to enforcement action (see ENF) and, in certain circumstances, to an action for damages.”

“The letter G is normally used to indicate guidance given under section 157. The guidance in the Handbook relates to the operation of the Act, the rules in the Handbook and other matters. ... Guidance may be used to explain the implications of other provisions, to indicate possible means of compliance, to recommend a particular course of action or arrangement, and for other purposes. Whatever guidance is used for, it is not binding on those to whom the Act and rules apply, nor does it have ‘evidential’ effect. It need not be followed in order to achieve compliance with the relevant rule or other requirement. So a firm cannot incur disciplinary liability merely because it has not followed guidance. Nor is there any presumption that departing from guidance is indicative of a breach of the relevant rule. Guidance is generally designed to throw light on a particular aspect of regulatory requirements, not to be an exhaustive description of firms’ obligations. If a person acts in accordance with general guidance in the circumstances



As a consequence, guidance is now more abbreviated than has previously been the case.

Where benefits are linked to an index, it might be possible to match by acquiring as assets the investments underlying the index. That situation would arise when the index is, for example, the FTSE-100 Index, and shares in the constituent companies of the index could be acquired with the appropriate index weighting.

Due to the nature of RPI, it is not possible to match the constituent parts of the index directly. The only appropriate matching assets are index-linked government stocks, index-linked corporate bonds, structured assets (an interest rate swap), or reinsurance.

Index-linked government stocks are of the correct nature but can rarely be acquired to match by term because of the limited number of stocks and the proximity of the longest-dated index-linked government stock, which matures in 2055.

Consider, for convenience, this latter problem in isolation for the moment: if the liability extends beyond 2055 the insurer must match with assets that are 'of appropriate security and marketability' and match 'as closely as possible'. Those assets could be other government stocks (which are of appropriate security and marketability but will have a fixed coupon and therefore would not match well) or index-linked corporate bonds or structured assets (which would match better but would need to be tested carefully against the security and marketability requirement). Rules on credit risk are set out in PRU 3.2.

Therefore, I believe that fixed coupon government stocks (which definitely meet the 'of appropriate safety and marketability' rule) would suffice to meet the close matching rule and there would be no prohibition on issuing liabilities beyond 2055.

It is open to the insurer to argue that another investment, which it considers to be a closer investment match, would be suitable if it could argue successfully that that

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contemplated by that guidance, then the FSA will proceed as if that the person has complied with the aspects of the rule or other requirement to which the guidance relates. ..."

Source: Reader's Guide: an introduction to the FSA Handbook, Chapter 6.



would not introduce too great a risk of failure of the security and marketability requirement.

PRU 4.2.59 G offers as guidance the statement that the firm is not permitted to hold different assets and to reserve excess assets to cover the mismatch. So, noting that this is guidance rather than a rule, deliberate mismatching is not permitted.

PRU 4.2.60 G then covers the situation that the firm may be unable to match its liabilities exactly by appropriate assets. In this situation, the guidance is for the firm to seek to match assets that at least cover the liabilities (my emphasis).

Finally, PRU 4.2.61 G guides the firm firstly to keep credit risk within acceptable limits and secondly to keep the value or yield in the assets, which do not exactly match fluctuations in the index, within acceptable limits. The former requirement covers the credit risk associated with reinsurance and counter-party risk associated with derivative and quasi-derivative contracts (rules 4.2.58 (3), (4), and (5)). The latter covers the closeness of immunisation<sup>4</sup> in the absence of matching.

#### ***4. Why might structured settlement annuities have a clause placing an upper limit on growth post-2055?***

Given that it is acceptable to create an index-linked liability post-2055, the reason why structured settlement annuity contracts have been written with a clause placing an upper limit on growth is simply one of prudence.

The European Commission requirement was based on the sound principle of limiting the potential for a life company to write unmatched linked liabilities. Notwithstanding any opinions that taking index-linked liabilities in the absence of index-linked gilts is legal, it seems that companies have taken the view that a voluntary adherence to the principle is appropriate. Annuity providers cannot be forced into writing lifetime index-linked annuities and, since annuity settlements have hitherto been by consent, it has been necessary for the claimants' advisers to balance the benefits to the claimant

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<sup>4</sup> See my note entitled "Immunisation", available from [www.carus-actuaries.co.uk](http://www.carus-actuaries.co.uk) under 'News'.



of the structured settlement annuities issued against the potential disadvantage of limited indexation post-2055.

This being the case, we are left with an interesting speculation. If the European Commission believes strongly enough to legislate that index-linked life liabilities should be closely matched and if life companies, with long experience of writing linked liabilities, choose to meet the spirit as well as the text of the requirement, then what problems will be stored up for the future in general companies who are required by law to issue unlimited index-linked liabilities and are not required to match them with appropriate assets even where these are available?

**5. *What options are available for defendants unable to self-fund periodic payments?***

Section 100(1) of Courts Act 2003 inserts a revised section 2 into the Damages Act 1996. Under this revised section 2(3),

‘A court may not make an order for periodical payments unless satisfied that the continuity of payment under the order is reasonably secure.’

Section 2(4) gives circumstances in which the continuity of payment will be considered to be secure. Discussion of this point is outside the scope of this note, but suffice to say that funds that are not protected by FSA compensation arrangements, or are not backed by Government guarantees, or claims which do not arise from compulsory insured classes, are likely not to meet the requirements and consequently cannot self-fund.

In this circumstance, the defendant will have to meet a periodic payment order through the purchase of a structured settlement annuity, which would at least meet the security requirement. It may not, however, meet any requirement for index-linking<sup>5</sup> since, as was noted above, the annuity may not offer unlimited index-linking.

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<sup>5</sup> See sections 2(8) and 2(9) of the Damages Act 1996, as inserted by section 100 of the Courts Act 2003.



Therefore, the defendant cannot simultaneously meet both the security and index-linking requirements and would not be able to satisfy a court order of index-linked periodic payments.

**If a defendant is unable to self-fund, and if the defendant cannot obtain an index-linked structured settlement annuity that has no limitations on indexation, then an index-linked periodical payment order may not be ordered against it.**

**6. *What links are appropriate for close matching?***

IPRU (INS) limits the assets to which a linked or index-linked contract may be linked and the only permitted index is RPI. Thus a structured settlement annuity could not be linked to average earnings: whilst there is currently no such restriction on periodic payments.

The tracing of the links is convoluted and is given in Appendix 3 of this note.

Again it will be noted that the link is restricted only for index-linked contracts and therefore applies only to life contracts and not periodic payments. This gives rise to further possibilities for regulatory arbitrage.

**An earnings-linked structured settlement annuity is not permitted but earnings-linked periodic payments would breach no regulations.**

***Present understanding***

This note is based on my present understanding of the legislation currently (February 2006) in force. Legislation may change at any time and is subject to judicial interpretation, and therefore my understanding of the legislation may also change from time to time.



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## **Appendix 1: Third Life Directive**

### **Reference**

**92/96/EEC** Council Directive of 10 November 1992 on the coordination of laws, regulations and administrative provisions relating to direct life assurance and amending Directives 79/267/EEC and 90/619/EEC (third life assurance Directive)

*Note that the Third Life Directive is no longer in force, having been repealed by the Life Assurance Directive **2002/83/EC**. However, the wording of Article 23 was carried over to Title III, Chapter 2, Article 25 of 2002/83/EC, the only changes being to referred paragraphs and a single grammatical correction.*

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Access to both directives can be obtained via:

[http://europa.eu.int/comm/internal\\_market/insurance/legis-inforce\\_en.htm](http://europa.eu.int/comm/internal_market/insurance/legis-inforce_en.htm)

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### **Text**

#### **Title III, Chapter 2, Article 23**

1. Where the benefits provided by a contract are directly linked to the value of units in an UCITS or to the value of assets contained in an internal fund held by the insurance undertaking, usually divided into units, the technical provisions in respect of those benefits must be represented as closely as possible by those units or, in the case where units are not established, by those assets.
2. Where the benefits provided by a contract are directly linked to a share index or some other reference value other than those referred to in paragraph 1, the technical provisions in respect of those benefits must be represented as closely as possible either by the units deemed to represent the reference value or, in the case where units are not established, by assets of appropriate security and marketability which correspond as closely as possible with those on which the particular reference value is based.
3. Articles 20<sup>6</sup> and 22<sup>7</sup> shall not apply to assets held to match liabilities which are directly linked to the benefits referred to in paragraphs 1 and 2. References to the technical provisions in Article 22 shall be to the technical provisions excluding those in respect of such liabilities.

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<sup>6</sup> General rule on diversification of assets to secure the safety, yield and marketability of assets

<sup>7</sup> Regulations relating to asset admissibility





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4. Where the benefits referred to in paragraph 1 and 2 include a guarantee of investment performance or some other guaranteed benefit, the corresponding additional technical provisions shall be subject to Articles 20, 21 and 22.



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## ***Appendix 2: Insurance Companies Act 1982***

### **Reference**

Insurance Companies Act 1982 (1982, Chapter 50)

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I cannot trace ICA 82 on the internet. Access will be required through a law library.

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### **Text**

#### **Section 35A Adequacy of assets**

- 35A (1) ...
- (2) A UK company which has entered into a linked long term contract shall secure that, as far as practicable, its liabilities under the contract in respect of linked benefits are covered as follows –
- (a) if those benefits are linked to the value of units in an undertaking for collective investments in transferable securities or to the value of assets contained in an internal fund, by those units or assets;
  - (b) if those benefits are linked to a share index or other reference value not mentioned in paragraph (a) above, by units which represent that reference value, or by assets of appropriate safety and marketability which correspond, as nearly as may be, to the assets on which that reference value is based.
- (3) A UK company which has entered into a linked long term contract shall also secure that such of its liabilities under the contract in respect of linked benefits as are not covered by contracts of reinsurance are covered by assets of a description prescribed by regulations<sup>8</sup> under section 78 below.
- (4) In this section –
- “linked benefits”, in relation to a contract of insurance, means benefits payable to the policy holder which are determined by reference to the value of or the income from property of any description (whether or not specified in the contract) or by reference to fluctuations in, or in an

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<sup>8</sup> Regulation 43 of The Insurance Companies Regulations 1994



index of, the value of property of any description (whether or not so specified);

“linked long term contract” means (subject to subsection 5 below) a contract of insurance,

(a) the effecting of which constitutes the carrying on of long term business; and

(b) under which linked benefits are payable to the policy holder.

- (5) In subsection (3) above “linked long term contract” does not include a contract the effecting of which constitutes the carrying on of long term business of class VII(a)<sup>9</sup>.

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<sup>9</sup> Pension fund management contracts.



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## **Appendix 3: IPRU (INS)**

### **Reference**

FSA Handbook of Rules: IPRU (INS) Vol. 1: Rules – Rule 3.7(1), Vol2: Appendix 3.2 Part II, and Volume 1: Definitions

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Access to IPRU (INS) can be made via:

[http://www.fsa.gov.uk/handbook/ipru\\_ins.pdf](http://www.fsa.gov.uk/handbook/ipru_ins.pdf)

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### **Text**

#### **Volume 1; Chapter 3; Part II LINKED LONG-TERM CONTRACTS Application**

- 3.7 (1) An *insurer* must not contract to provide benefits under any contract to which this rule applies which are determined, either wholly or partly:
- (a) ...
  - (b) whether directly or indirectly, by reference to fluctuations in any index of the value of property other than an index set out in Part II of **Appendix 3.2**.
- .....

#### **Volume 2; Appendix 3.2:**

#### **PART II INDICES BY REFERENCE TO WHICH BENEFITS MAY BE DETERMINED**

- 1 An *approved index*.
- .....



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**Volume 1; Chapter 11; Annex 11.1**  
**Definitions**

- approved index* (a) ...
- (b) a national index of retail prices published by or under the authority of a government of a State belonging to Zone A as defined in the *Banking Co-ordination Directive*; or
- (c) ...



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## ***Appendix 4: Integrated Prudential Sourcebook (PRU)***

### **Reference**

FSA Handbook of Rules: PRU Chapter 4, Section 4.2 'Market Risk in Insurance'.

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Access to PRU 4.2 can be made via:

<http://fsahandbook.info/FSA/html/handbook/PRU/4/2>

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### **Text**

#### **4.2.57 R Covering linked liabilities**

*A firm must cover its property-linked liabilities with:*

- (1) (as closely as possible) the assets to which those liabilities are linked; or
- (2) a property-linked *reinsurance* contract; or
- (3) a combination of (1) and (2).

#### **4.2.58 R** *A firm must cover its index-linked liabilities with:*

- (1) either:
  - (a) the assets which represent that index; or
  - (b) assets of appropriate security and marketability which correspond, as closely as possible, to the assets which are comprised in, or which form, the index or other reference of value to which those liabilities are linked;  
or
- (2) a portfolio of assets whose value or yield is reasonably expected to correspond closely with the index-linked liability;  
or
- (3) an index-linked reinsurance contract; or
- (4) an index-linked approved derivative; or
- (5) an index-linked approved quasi-derivative; or
- (6) a combination of any of (1) to (5).

**4.2.59 G** For the purposes of PRU 4.2.57 R and PRU 4.2.58 R, a firm is not permitted to hold different assets and to cover the mismatch by holding excess assets.



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- 4.2.60 G** If a *firm* has incurred a *policy* liability which cannot be exactly matched by appropriate assets (for example the Limited Price Index (LPI), the *firm* should seek to match assets that at least cover the liabilities. For example, an LPI limited to 5% per annum may be matched by an RPI bond or a fixed interest investment matching cash flows increasing at 5% per annum compound.
- 4.2.61 G** In selecting the appropriate cover, the firm should ensure that both credit risk, and the risk that the value or yield in the assets will not, in all circumstances, match fluctuations in the relevant index, are within acceptable limits. *Rules* and *guidance* relating to credit risk are set out in PRU 3.2.



## Appendix 5: Glossary

### Reference

FSA Handbook of Rules: Glossary.

Access to the Glossary can be made via:

<http://fsahandbook.info/FSA/html/handbook/Glossary>

The following are selected definitions extracted from the Glossary.

|                                  |  |
|----------------------------------|--|
| <i>authorised person</i>         | (in accordance with section 31 of the Act (Authorised persons)) one of the following:<br>(a) a person who has a Part IV permission to carry on one or more regulated activities;<br>(b) an incoming EEA firm;<br>(c) an incoming Treaty firm;<br>(d) a UCITS qualifier;<br>(e) an ICVC;<br>(f) the Society of Lloyd's.<br>(see also GEN 2.2.18 R for the position of an authorised partnership or unincorporated association which is dissolved.)  |
| <i>firm</i>                      | an authorised person, but not a professional firm unless it is an authorised professional firm.  |
| <i>index-linked benefits</i>     | benefits:<br>(a) provided for under a linked long-term contract of insurance; and<br>(b) determined by reference to an index of the value of property of any description (whether specified in the contract or not).   |
| <i>index-linked liabilities</i>  | insurance liabilities in respect of index-linked benefits.   |
| <i>linked long-term contract</i> | (in relation to a class of contract of insurance) the class of contract of insurance, specified in paragraph III of Part II of Schedule 1 to the Regulated Activities Order (Contracts of long-term insurance), on human life or contracts to pay annuities on human life where the benefits are wholly or partly to be determined by reference to the value of, or the income from, property of any description (whether or not specified in the contracts) or by reference to fluctuations in, |





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|                                    |  |
|------------------------------------|--|
|                                    | or in an index of, the value of property of any description (whether or not so specified).             |
| <i>property-linked benefits</i>    | benefits other than index-linked benefits provided for under a linked long-term contract of insurance. |
| <i>property-linked liabilities</i> | insurance liabilities in respect of property-linked benefits   |