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16 March 2005

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Financial Engineering

The subject of financial engineering, including finite reinsurance, and its potential to obscure or conceal the true financial position of a firm has been the focus of attention in a number of countries recently. The purpose of this letter is to inform you of the FSA's work in respect of financial engineering and to ask you to supply some information by end April.

Background

In 2002, the FSA issued CP 144 on "*A new regulatory approach to insurance firms' use of financial engineering*". In summary, this indicated that properly constructed and presented financial engineering can be a valid method of strengthening a firm's solvency position where there is genuine and material transfer of risk to an unconnected counterparty. However, the Consultation Paper also highlighted that financial engineering (including arrangements or letters linked in some way) could be used to obscure the underlying financial condition of a firm, thereby misleading consumers or regulators. If used in this manner, firms could be in breach of the requirement (for example under Threshold Condition 4 and Principle 4) to hold adequate and suitable financial resources as well as Principle 11 which requires firms to deal in an open and honest manner with their regulator. There are, of course, other specific requirements which the use of financial engineering could call into question, for example compliance with prudential rules, accounting standards and rules for publicly listed companies.

More recently in December last year, we reminded firms via the General Insurance Newsletter of the FSA's views on this issue. That reminder included our expectation that firms have appropriate systems, controls and governance arrangements in place and senior management understand and mitigate against the risks arising from their business. These high level principles apply to all regulated firms but are of particular importance to us when assessing an insurer's financial position and the accuracy of its regulatory reporting. We also referred to supervisory and enforcement action we have taken against firms and their senior management for entering into financial arrangements, or side letters to financial arrangements, to distort the financial results of their companies.