

CP190: A new capital regime for non-life insurers

August 2003

Introduction

The FSA recently published Consultation Paper 190 (CP190), which set out its proposals in respect of enhanced capital requirements and individual capital assessments for non-life insurers. In a press release to coincide with the publication of CP190 FSA Managing Director, John Tiner said "While there have been very few failures amongst UK general insurers in the retail market, the failure rate amongst London market insurers over the last 20 years has been too high. Weak capital requirements and management practices played a major part in this [failure rate]." Mr Tiner went on to say that "For some non-life insurers the new requirements will have only a modest effect because they hold capital well in excess of the proposed requirements either for strategic reasons, risk sensitivity, to fund expected growth or for credit rating purposes. However for other non-life firms it could require them to respond by either raising new capital or by reducing the risks they face or underwrite."

On the same day the FSA published a policy statement that sets out the broad direction in which Individual Capital Adequacy Standards (ICAS) will be developed for other types of authorised firms. CP190 is specific in that it provides detailed rules and guidance on the ICAS proposed for non-life insurers. CP190 also:

- introduced proposed changes in the definition of capital to align it with that proposed for banks; and
- confirmed the FSA's intention to monitor reinsurance credit risk in the way outlined in CP143.

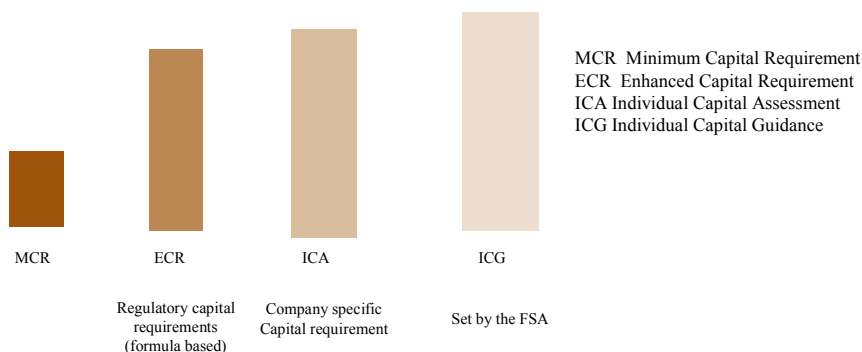
Proposals for non-life insurers

Central to the FSA's proposals are:

- a new risk-based minimum regulatory capital requirement (ECR). It is expected that around 25% of insurers will need to raise additional capital to meet the ECR soft test (ECR including a 25% capital buffer); and
- a regime under which the FSA will review firms' assessments of their capital needs. In so doing the FSA will take these assessments into account together with their own views of the capital that would be adequate to achieve their regulatory objectives. As a result of this review the FSA will issue Individual Capital Guidance (ICG) to firms where their assessment indicates that adequate capital is greater than the minimum (or will confirm that the minimum is adequate). It is expected that around 60% of insurers may have to raise additional capital in this regard.

CP190 does not apply to Lloyd's of London. However, the FSA has indicated that it intends to develop rules for Lloyd's that are consistent with those proposed in CP190.

Figure 1: Details of capital framework



Scope

The FSA is proposing that the ECR should apply to all non-life insurers, including reinsurers and non-EEA firms operating a UK branch with the following exceptions:

- mutual insurers not subject to the insurance directives. These insurers will be subject to the minimum capital requirement;
- Swiss general insurers operating through UK branches and EEA-deposit insurers; and
- firms in run-off, that is, their Part IV permission has been varied, before the date at which the ECR will become a prudential requirement, to remove the regulated activity of effecting contracts of insurance.

The new minimum Capital Resource Requirement

Firms will be required to hold capital of the quality prescribed in PRU 2.2 sufficient to meet the higher of the:

- Minimum Capital Requirement (MCR), being the minimum requirements established by EU Directives; and
- Enhanced Capital Requirement (ECR), being an FSA prescribed, risk-sensitive calculation.

Figure 2: ECR framework

Asset-related values * Relevant asset factors (%) =	X
Insurance-related values * Relevant technical provision factors (%) =	X
Net written premium * Relevant premium factors (%) =	X
Total ECR (before equalisation adjustments)	<hr style="width: 100%;"/> X

- The asset-related values to which the relevant factors are applied are calculated after the application of valuation and admissibility rules. This category includes reinsurance debts.
- The insurance-related values comprise (for each class of business and form of risk acceptance), the total technical provisions, including outstanding claims, IBNR and IBNER claims, unearned premiums reserves and any additional unexpired risk reserves.
- Premium values to which relevant factors are applied are written premiums net of reinsurance, but before deduction of commission.
- Equalisation reserves will be treated as capital for the purposes of meeting the ECR. Discounting will effectively be disallowed and inadmissible assets will remain inadmissible for the purposes of determining capital resources available to meet the ECR.

With the exception of additional information in respect of derivatives, the ECR is capable of calculation from information currently generated by firms to meet existing reporting requirements.

- The capital factors to be applied are designed to reflect the nature of business being written and the inherent risk involved. In selecting factors for this consultation, the FSA has weighted the calibration towards achieving a closer fit for the minimum requirements for larger firms. These factors lead to capital requirements that are estimated, on average, to exceed current EU requirements by roughly 150%.
- The FSA estimates smaller firms will require proportionally 20% to 80% more capital than a large well diversified firm to achieve the same confidence level.

Introduction and reporting of the ECR

No decision has been made as to when the ECR will be introduced as a prudential requirement. The FSA expects to be in a position to do so during 2004 but has said that in so doing it will give firms 12 months notice before the ECR becomes a requirement. The actual date will be influenced by feedback on CP190, progress made in respect of Solvency 2, market conditions and the receipt of further information from firms (particularly groups).

Until the ECR becomes a prudential requirement, firms will be required to calculate their ECR and report their capital position compared with their ECR privately with the FSA. This reporting will take place at the same time as public returns are submitted to the FSA for periods ending on or after 31 December 2004.

After the ECR becomes a prudential requirement it is proposed that it will be reported as part of the insurance annual return, which are publicly available at present.

Particular issues arise for firms in run-off. For those in run-off before the ECR is introduced, the ECR will be equivalent to existing capital until the calculated ECR is met. Capital will be "locked-in" for as long as this takes.

Waivers

The FSA accepts that it is possible, for a few firms, that the ECR may produce a capital requirement considerably in excess of the amount of capital that is adequate for a firm's business and control risks. In these circumstances the FSA has indicated it may grant waivers modifying the ECR. CP190 identifies two such situations:

- the nature of an insurer's business is such that it is obvious that the ECR calculation is inappropriate; or
- a firm has developed models or analyses that indicate convincingly that a lower capital requirement is appropriate.

It should however be noted that:

- firms will also be required to meet the MCR requirements (which are EU directive requirements and cannot be waived);
- before a waiver can be granted certain statutory tests must be met; and
- waivers are published unless the FSA is satisfied it is inappropriate or unnecessary to do so. In the case of ECR waivers (if any), CP190 indicates that the FSA would expect the existence of the waiver to be made public rather than its precise terms.

Individual Capital Assessment (ICA)

Each company will need to make its own assessment of the capital it views as adequate for the size and nature of its business (ICA), taking into account major sources of risk and evidence of capital needs from stress and scenario testing.

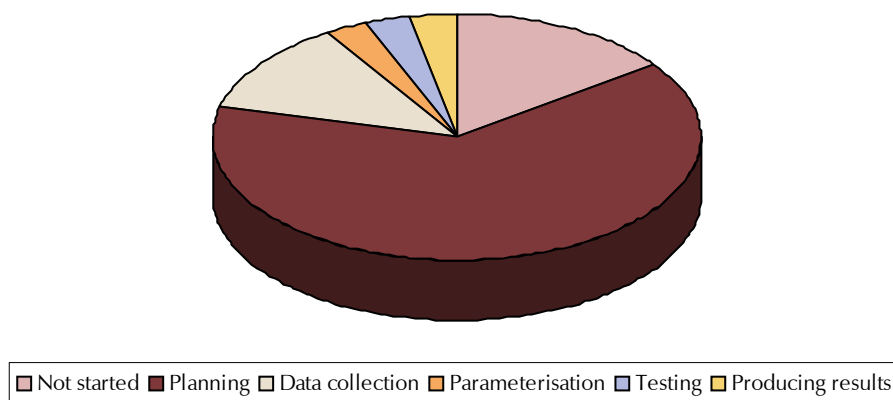
The FSA will not prescribe calculations for the amount or quality of capital, but the FSA specifies risk areas firms should consider and the type of assessments they should carry out. In order to determine the ICA senior management will have to make the following two judgements:

- the approach to risk aggregation; and
- the confidence level at which capital is judged to be adequate.

These requirements will be in place from 1 January 2005 but the FSA has indicated that during 2004 it will be asking some firms to submit quantitative self-assessments of the amount of capital they should hold.

A recent survey by PricewaterhouseCoopers indicates that the majority of the industry is currently not in a position to submit a self-assessment with most companies being in the planning phase of the implementation.

Figure 3: ICA progress



Individual Capital Guidance (ICG)

As noted above the ICG will be advised by the FSA and will represent the FSA's judgement of an individual company's capital requirements. This will include the company's own ICA, risk and capital management processes. The ICG is therefore intended to provide an incentive for insurers to have in place good risk management practices.

In general, the ICG will be higher than the ECR as the ECR proposed, when finally calibrated, will represent the minimum level of capital which a large, well run, well diversified insurer could expect to regard as adequate. The FSA recognises that the initial exercise to give ICGs might last two or three years. Once the initial exercise is complete, ICGs will be reassessed as part of the FSA's continuing monitoring programme.

Groups

CP190 does not deal with group capital requirements i.e. obligations imposed on regulated firms within a group to ensure they, or their parent company or companies, maintain adequate capital in the group as a whole.

The FSA expects that changes to group requirements will soon be necessary to implement the Financial Groups Directive (FGD), which will in turn modify the Insurance Groups Directive (IGD).

The revised draft PRU rules published as part of CP190 do however include a change to the way in which firms would measure the surplus assets of insurance subsidiaries. The solvency margin of the subsidiary to be taken into account when determining surplus assets will be based on the ECR; this is likely to reduce the valuation of the subsidiaries for the purposes of group solvency. However this change will not apply until the ECR becomes a prudential requirement. Prior to this date firms will be able to determine surplus assets of insurance subsidiaries using a solvency margin based on MCR.

Definition of capital for the purposes of meeting minimum capital requirements

CP190 proposes to introduce changes to the definition of capital to align the definition of capital for insurers more closely with that proposed for banks. The PRU approach to measuring capital resources is to identify the components of capital. As well as defining the components of capital, capital is also divided into categories, or tiers, reflecting differences in the extent to which the various types of capital meet the characteristics of permanency and loss absorbency that are features of the highest quality, or tier 1, capital.

Credit risk changes proposed for non-life insurers in CP143

In CP143 the FSA, amongst other things, consulted on credit risk for insurers and in particular, revised flexible limits on reinsurance concentration. In CP190 the FSA states that it accepts that there are instances where imposing hard limits on the levels of reinsurance will not be appropriate. However, it is clear that credit risk arises on such transactions and needs to be controlled. Therefore the FSA intends to leave the rules requiring firms to inform it of large reinsurance arrangements, with the onus being on the firm to demonstrate that credit risk is being effectively managed. Accordingly, the FSA will require firms to notify it and either justify or agree a plan to reduce reinsurance under which:

- in excess of 20% of gross earned premium in any one financial year is credited to any one reinsurer and its connected parties; or
- booked recoveries (including IBNR) from any one reinsurer and its connected parties exceed 100% of capital.

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Business impact

The FSA intends to move ahead with these proposals during 2004. Firms therefore need to move quickly to ensure that they:

- have adequate systems and resources in place;
- have an appropriate methodology in place for their internal capital assessment;
- integrate and link the capital assessment to their management information, business planning, risk management and strategic management approaches;
- embed their ICAS processes into decision-making;
- educate shareholders and analysts as to the implication of revised capital needs;
- address how to raise any necessary additional capital, including that in innovative form;
- consider the particular implications for firms in run-off, or with the potential for run-off.

PricewaterhouseCoopers LLP

If you would like to discuss any of these issues arising from the proposals, please speak with your usual contact at PricewaterhouseCoopers, or one of the people listed below:-

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