

CP195: A new capital regime for life insurers

August 2003

Introduction

This paper is a summary of CP195 which has recently been released by the Financial Services Authority. CP195 addresses reserving and capital requirements for life insurers and will have a significant effect on life companies. Although this should not be read as a substitute for the CP, we hope it provides a useful summary.

CP195 sets out proposals for the capital requirements to be contained in the Integrated Prudential Sourcebook (PSB). The paper extends the Basel 2 'three pillar' approach¹ to life insurers with a view to achieving a more harmonised approach between banks and insurance firms.

It devotes considerable attention to reserving and capital requirements for life insurers writing with-profits business, together with the associated reporting and disclosure requirements, and takes forward the stress and scenarios testing under the Individual Capital Adequacy Standards framework introduced in CP136. It also introduces a number of changes to the reserving requirements for all life insurers.

The FSA proposes to introduce these new rules as part of its integrated PSB implementation during late 2004. Life insurers writing with-profits business will need to meet revised capital requirements from that date. This contrasts with the equivalent proposals for general insurers, for which the FSA has deferred the introduction of a "hard" test.

¹ CP136 describes the three pillars approach as: Pillar 1 provides the minimum capital requirements; Pillar 2 covers the supervisory review process (including the need to set capital requirements above the Pillar 1 minimum) and Pillar 3 addresses market discipline through enhanced market disclosure.

Pillar 1 capital requirement

Under the PSB, the main principle for the Pillar 1 capital requirement is that both life and non-life firms hold financial resources in excess of a capital resources requirement (CRR). The PSB introduces a series of new terms and acronyms to define the various components of the CRR for each type of firm.

In broad terms, all life firms must hold regulatory capital in excess is the higher of the MCR and the ECR (if applicable). These terms are explained below:

- The minimum capital requirement (MCR) is the higher of the minimum guarantee fund and the sum of the required minimum margin and resilience test. CP195 has confirmed proposals given in CP143.
- The enhanced capital requirement (ECR), for life firms with aggregate with-profits liabilities in excess of £500m, is the sum of the required minimum margin, the resilience test capital amount and the with-profits insurance capital component.

With-profits insurance capital component

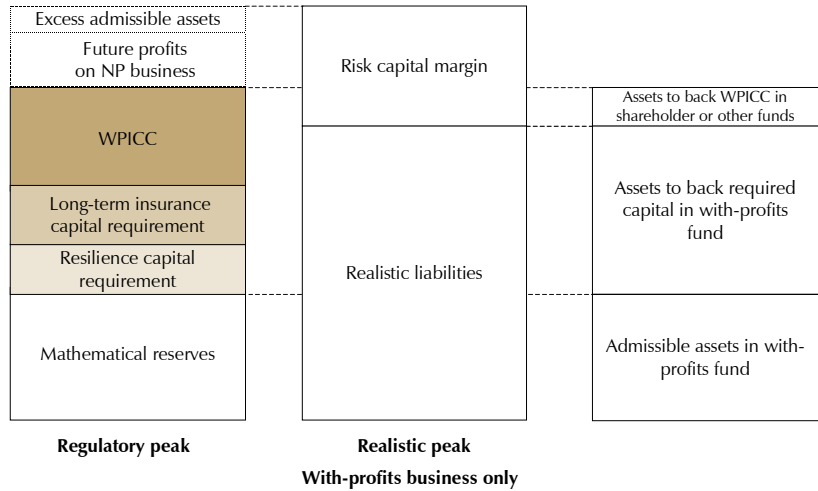
For those life firms falling within the scope of the ECR, the purpose of the with-profits insurance capital component (WPICC) is to ensure that these firms hold adequate financial resources for their with-profits business, including provision for final bonuses. The amount of the WPICC is determined by way of a 'twin peaks' calculation applied to each of a firm's with-profits funds, which compares:

- the mathematical reserves (as revised from current calculations as described below) plus allocated required minimum margin plus allocated resilience test (in total, the 'regulatory peak'); with
- the realistic value of contractual and constructive liabilities plus a risk capital margin (the 'realistic peak').

Certain realistic assets of a with-profits fund - the embedded value of any non-profit business written in the with-profits fund and the fund's admissible assets in excess of counterparty and market exposure limits - can be offset against the fund's realistic peak.

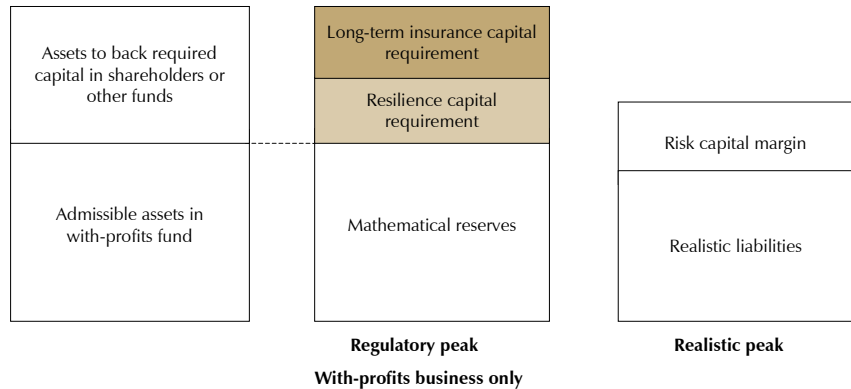
Where this realistic peak exceeds the regulatory peak, the WPICC is the amount of capital required to bring the regulatory peak up to the level of the realistic peak.

Figure 1: WPICC is required



In this illustration, a WPICC is required to ensure that the regulatory peak equals the realistic peak. The with-profits fund must have sufficient capital to cover the realistic liabilities. Any capital that is required to back part of the WPICC can be held outside the long-term fund and backed with shareholder capital or other fund surpluses.

Figure 2: Realistic peak is less than the regulatory



In this case, the realistic peak is less than the regulatory peak. As currently, assets must be held in the with-profits fund to cover the mathematical reserves.

Non-profit business effectively continues to be valued under the mathematical reserving requirements with prudential margins, appropriate required minimum margin and resilience capital.

Realistic peak

The realistic value of liabilities represents all contractual and constructive liabilities to policyholders and is the sum of:

- the value of basic policy liabilities (the with-profits benefits reserve), to be determined by either a retrospective 'asset share' approach or by way of a prospective 'bonus reserve valuation' method;
- the net costs of guarantees, options and smoothing (the future policy related liabilities), to be valued using stochastic methods, market costs of hedging or a series of deterministic projections; and
- a realistic assessment of current liabilities.

Since mid-2002, larger with-profits firms have participated in a six-monthly realistic reporting exercise, submitting their realistic balance sheets privately to the FSA.

The proposals also require a risk capital margin to be held to cover the capital needs that would arise as a result of specified stress scenarios for:

- Market risk (consisting of the same equity, real estate and interest rate stress tests applied for the resilience capital requirement but applied to the realistic liability);
- Credit risk (consisting of counterparty risk to corporate debt issuers and external reinsurers); and
- Persistency risk (consisting of a 50% decrease in early voluntary termination rates across all durations).

The risk capital margin is based on a straight aggregation of the effects of the different risks. Other risks such as operational risk would not be explicitly addressed under the Pillar 1 capital requirement. The FSA intends to commission further calibration work in the near future in relation to the risk capital margin.

In projecting the effect of the stress scenarios, firms can reflect the foreseeable management actions appropriate to the conditions in the scenario. These might include changes in bonus rates, reductions in surrender values and the amount of charges deducted from asset shares.

The valuation methodology and assumptions used to determine the realistic peak (and effectively the realistic balance sheet) and the assumed management actions need to be consistent with a firm's duty to treat its customers fairly and its Principles and Practices of Financial Management (PPFM)².

² Firms must make their PPFM available by 31 March 2004. Further details are given in the FSA's feedback statement on CP167

Regulatory reporting and disclosure requirements

The paper introduces two new regulatory reporting forms: Form 19 (realistic balance sheet) and Form 18 (the twin-peaks calculation). It also sets out the proposed disclosures relating to the realistic valuation to be made in Appendix 9.4A of the Interim Prudential Sourcebook, the realistic equivalent of the abstract of the valuation report for the statutory valuation. Both the forms and the disclosures will be publicly available. The forms and some aspects of the disclosure will be subject to audit. Further details of proposed changes to the nature and scope of the regulatory reporting forms and related disclosures will be given shortly in a CP on regulatory reporting.

This CP proposes that Forms 18 and 19 and the associated valuation report should be submitted on a six-monthly basis.

Changes to mathematical reserves

In March 2003, the FSA invited those firms participating in the six-monthly realistic reporting exercise to apply for waivers from certain mathematical reserving requirements. These waivers were effectively a first step towards implementing changes to the reserving requirements for life firms falling within the scope of the ECR. The proposed changes are shown in the table below, some of which apply to all life firms.

Figure 3: Proposed changes to mathematical reserves

	Life firms falling within the scope of the ECR	Other firms
Reserving for conventional with-profits business	Gross premium method can be used	Net premium method still applies.
Reinvestment rate assumptions for with-profits business	Reinvestment rates must not be more than rates derived from the forwards gilt yield	Current restriction based on long-term gilt yields still applies
Persistency assumptions for with-profits business	A prudent allowance can be made for future policy lapses on with-profits business	Current rule applies, i.e. no allowance can be made for future policy lapses where liability would be reduced
Equity yield assumption for all business	Removal of upper limit on assumed equity yield of twice the dividend yield.	Removal of upper limit on assumed equity yield of twice the dividend yield.
Reserving for guaranteed annuity options	Further guidance on assumed take-up rates and, where a stochastic or market valuation approach is not possible, the use of a series of deterministic projections	Further guidance on assumed take-up rates and, where a stochastic or market valuation approach is not possible, the use of a series of deterministic projections

Pillar 2 capital requirement

Under the PSB, all life firms including reinsurers will be required to self-assess the extent to which their CRR is adequate for their particular circumstances, taking into account their particular business and control risks. To meet this requirement, a firm will need to consider the extent to which Pillar 1 capital is appropriate for the risks identified and assess the amount and quality of capital required.

The FSA will review the results of this self-assessment – and the processes and systems used - and may give individual capital guidance (ICG), either confirming the Pillar 1 CRR or stating that an additional amount of capital should be held.

The firm's assessment of its own capital resources would remain private between itself and the FSA. Our expectation is that this self-assessment process may start in 2004 although the FSA states that the initial exercise of reviewing the self-assessment may last two or three years.

Definition of capital

As well as addressing the calculation of required capital resources, the CP addresses the forms of capital that can be used to meet these requirements. In particular, in meeting the ECR, insurers will be able to use innovative capital instruments (within certain limits) similar to those currently used by some UK banks.

The CP also sets out the FSA's proposals in respect of the inclusion of implicit items in capital resources in meeting the MCR in line with the requirements of the EU Solvency 1 Directive. The FSA proposes to limit implicit items to 25% of the required solvency margin by March 2007 and to reduce the amount to nil by the end of 2009.

Business impacts

All PSB requirements for systems and controls, capital and reserving for life insurers are due to be implemented in 2004. For life firms falling within the scope of the ECR, this timetable means that their realistic balance sheet will be audited and publicly disclosed as part of the FSA Annual Returns for that year.

These firms will need to have the system capabilities and resources capable of producing results which are robust enough to be reliable and auditable – and explainable - all within the year end valuation process.

Some of the key implementation questions will be:

- What are the resource requirements, what impact will this have on the year-end timetable and what will be the cost of implementing the required changes?
- How robust are current realistic calculations and systems?
- Is the reporting process up to audit standard? If not, what further work is required?
- How to ensure that the methodology and assumptions are consistent with the PPFM?

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Business implications will also need to be considered, for example:

- further education of shareholders and analysts will be required as to the realistic balance sheet, including dispelling any negative perceptions surrounding a firm's WPICC;
- management will need to understand, and be able to explain to shareholders, analysts and the FSA, the movements in the realistic and regulatory balance sheets and the dynamic interaction between them;
- the assessments performed as part of the Pillar 2 will need to be robust, clearly understood by management and fully embedded within ongoing reporting processes; and
- ensuring sufficient capital is available in the with-profits fund to meet the revised solvency requirements.

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

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