

190 newsletter

Financial Services Authority Enhanced capital requirements and individual capital assessments for non-life insurers CP190

July 2003

About this newsletter

This newsletter provides a summary of FSA Consultation Paper 190

This paper is particularly relevant for non-life insurers

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Executive summary

Non-life insurers must hold enough capital to absorb unexpected losses. However, the minimum regulatory requirements are based on EU directives that go back to 1973. These are widely thought to set levels that are too low and not risk-sensitive.

A new directive¹ will shortly be implemented to increase capital requirements from 2004, but the improvements are modest. They are mainly a temporary measure while there is a review of insurers' (and reinsurers') capital requirements². However, this review is unlikely to result in new directive requirements for several years.

This situation has led regulators in the UK and elsewhere to adopt alternative approaches to prudent insurance regulation. In the UK, we generally expect insurers to hold twice the EU minimum requirement, or a higher multiple for some types of business.

Our proposals for non-life insurers include:

- a new risk-based minimum regulatory capital requirement (ECR)³; and
- a regime under which we will review firms' assessments of their capital needs. We will take this into account with our own views of the capital that would be adequate to achieve our statutory objectives, and give individual capital guidance (ICG) to firms.

We do not seek to operate a regulatory regime with no failures. However, we consider that a higher and more risk-sensitive capital requirement will lead to:

- a more transparent regime;
- earlier regulatory intervention when financial problems develop; and
- closer alignment of capital with risks.

We consider that it is necessary to start implementing our proposals now rather than await the conclusion of international discussions, which may take some considerable time. To some extent the ECR merely makes explicit some of the implicit supervisory practices both in the UK and other EU member states which are designed to overcome the low level and lack of risk sensitivity of the current minimum capital requirement. The changes are consistent with modernisation recommendations made

1 Directive 2002/13/EC ("Solvency 1").

2 "Solvency 2" and a new directive affecting firms carrying on only reinsurance "the reinsurance directive".

3 We have previously referred to our plans to introduce the Enhanced Capital Requirement (ECR – previously called an 'enhanced pillar 1') in consultation papers CP115 and CP136, in the final 'Tiner report' and in our plan and budget for 2003.

by the International Monetary Fund in its recent UK Financial System Stability Assessment.

The ECR will raise the explicit minimum regulatory capital requirement so that it is above the current explicit minimum for non-life insurers based in other EU member states. However, it does not necessarily follow that the capital costs for UK authorised firms will be greater than at present or greater than in other EU member states.

How will these proposals affect firms?

For many non-life insurers our proposed requirements will have only a modest effect. This may be because they hold more capital than the proposed requirement, either because they choose to do so or because we have informally suggested that they do so. Firms may choose to hold more capital for strategic reasons, to fund expected growth, because they take a risk sensitive view, or for credit rating purposes. However, under our proposals there may be a need for some firms and groups to enhance their capital or to reduce the risks they face or underwrite.

We expect to decide during 2004 a date by which firms will be required to hold capital at least equal to the ECR and a date from which firms will be required to report the ECR in public regulatory returns. We will give at least 12 months' notice of this date and take into account feedback to this consultation paper including views on the calibration of the ECR, market conditions, and the progress made with Solvency 2. We will also consider any further analysis of capital strength (including the strength of any group of which a firm is a member) which firms provide as part of the individual capital assessments that we are proposing they should begin during 2004. Until holding capital at least equal to the ECR becomes a prudential requirement, we are also proposing rules that require firms to report privately to us their ECR calculation along with returns submitted for 31 December 2004 onwards.

In developing the ECR we have commissioned an actuarial study from Watson Wyatt LLP on the volatility of UK non-life insurers' experiences and this has played an important part in calibrating the ECR. Later this month we will publish the results of this actuarial study.

Separate consultations on individual capital adequacy standards (ICAS)

The broader regime for assessing ICAS (not just non-life insurers) has also been the subject of consultation in Consultation Paper 136 (CP136). We are publishing a policy statement at the same time as this paper that sets out a summary of responses to CP136. That policy statement sets out the broad direction in which ICAS will be developed for deposit takers and investment firms, but this consultation paper provides detailed rules and the guidance in the ICAS proposed for non-life insurers.

Other firms may be interested to see how the higher-level ICAS rules might apply to them in due course. Before applying an ICAS regime to other firms, we will of course consult and provide detailed rules and guidance for those firms and appropriate cost benefit analyses. The ICAS framework will be introduced as part of the integrated prudential sourcebook (PRU). For insurers (life and non-life) this will be in 2004 and for banks and principal position taking investment firms at the end of 2006.

Under ICAS, we propose to require non-life insurers to carry out regular assessments of the amount and quality of capital, which in their view is adequate for the size and nature of their businesses. We would regard this as good management practice. We do not prescribe calculations (for either the amount or quality of capital) that firms might undertake as part of their assessment. However, we do specify the risk factors firms should consider and the types of assessment they must or may carry out.

As part of the introduction of this framework for non-life insurers, during 2004 we will be asking some firms to send us the results of their assessment in a quantitative form. This will give us a basis for our view of the amount of capital they should hold (individual capital guidance - ICG). The results of the ECR calculation will be an important factor when forming our views on ICG and we would expect firms to start calculating their future capital requirements using our proposed ECR as soon as practical. Where anticipated ICG levels might require a change in strategy or capital, we expect firms to discuss their position with their supervisors as soon as possible.

We will not require all firms routinely to report their assessments to us. Firms may develop more sophisticated approaches and models as part of their own risk management processes. In these cases we will consider the results as part of our assessment of capital adequacy and this may provide a better starting point than the ECR, so that ICG could be below the ECR level.

Next steps

We invite views on this consultation paper from all interested parties whether non-life insurers, consumers, or other interested parties. Responses should be sent to us by 30 November 2003. Anyone wishing to respond to this consultation may also wish to take account of Watson Wyatt's report.

Separately, we intend to issue a related consultation paper on corresponding capital requirements for life insurers in the next month or so. That paper will introduce enhanced capital requirements for life insurers. These result from incorporating capital requirements for with-profits business based on a comparison of the current reserving requirements with the sum of more realistic reserving methods and a capital margin. The CP will also introduce rules and guidance for life insurers' individual capital assessments.

We have also recently published a consultation paper (CP178) on the review of prudential rules that we have started for Lloyd's. CP178 sets out the lines along which we intend to develop requirements to apply to the Society of Lloyd's and managing agents, to ensure robust prudential regulation of the market as a whole. We will be consulting further on equivalent capital adequacy requirements to those in this paper for the Lloyd's market. These will be in proportion to the benefits and further our statutory objectives.

Consumers

This paper will be of interest to consumers. The issues it discusses link mainly with the market confidence and consumer protection objectives.

Consumers will be interested in the effect that strengthening the capital position of some insurers might have on the cost and availability of insurance cover.

They may wish to balance this against increased confidence in the ability of non-life insurers to meet claims and potentially fewer failures amongst non-life insurers. Capital requirements that are more aligned with the risks underwritten by insurers should lead to a more efficient market.

The Financial Services Authority invites comments on this Consultation Paper. Please send your comments to reach us by 30 November 2003.

You can send your comments electronically using the form on the FSA's website (www.fsa.gov.uk/pubs/cp/cp190_response.html).

Alternatively, you can send comments in writing to:

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It is the FSA's policy to make all responses to formal consultation available for public inspection unless the respondent requests otherwise.

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