REGULATORY BRIEFING:

FSA CP136 – INDIVIDUAL CAPITAL ADEQUACY STANDARDS

What is it?

CP 136 sets out the FSAs thinking on a new solvency margin regime. This new regime will use a risk based capital approach rather than the current formulaic solvency margin.

Who will it apply too?

The new regime will apply to all insurance companies and friendly societies, both life and general. It will also apply to banks and principal position takers. In addition certain elements of the new regime could apply to any regulated firm.

When will it happen?

Implementation will be as part of the new Integrated Prudential Sourcebook (PSB) which is due to come in force for insurance companies in 2004.

What other solvency capital reviews are taking place?

In the current regulatory environment it would be surprising if only one review were taking place! For solvency capital there is also a review at the EU level called Solvency II. This will eventually result in EU legislation which will set new minimum standards which UK firms will also have to comply with.

How does the new approach differ from the current solvency margin?

The current solvency margin is based upon a formula. For life companies this is a percentage of reserves and an amount per £1000 sum at risk. For general business the margin is the greater of two calculations based upon premiums and claim payments. Both approaches are mechanical in application.

The new regime will involve holding up to three components of solvency margins:

- A formula based margin similar to the current approach. This will be 'enhanced' over the current required EU minimum.

- Internal Capital Assessment ('ICA') – to be calculated by each firm based upon its individual risks.

- Supplementary Capital Assessment ('SCA') – to be imposed by the FSA upon certain firms which either have special risks or are perceived to have weak controls.

How will the Internal Capital Assessment (ICA) be calculated?

The ICA will be calculated on a risk based approach. Risks will be included in the assessment to the degree that they are not adequately allowed for in the formula component. The FSA envisages that the ICA could be calculated either by:

- Stress and scenario testing.
- Use of an Economic Capital model.

There is also some discussion of stochastic modelling which would be most applicable where there are options in contracts (for example guaranteed annuities). It is expected that most insurance companies would use the stress and scenario testing approach.

It is likely that the FSA will lay down detailed guidance as to the method and basis to be used in the calculation of the ICA. Individual companies will then calculate the ICA based upon their own assessment of the particular risks the company faces. This calculation must be approved by the senior management of the firm. It will then be submitted to and reviewed by the FSA.

What are the risks which the ICA will take into account?

The risks to be covered are:

- Credit risk (counter party failure)
- Market risk (movement in asset values and interest rates)
- Operational risk
    - residual risk (failure of risk mitigation due to elements such as a failure in document or treaty wording)
    - legal and litigation risk
    - strategy risk (failure of a firm to develop and implement a sound strategy)
- Insurance risk (incidence and severity of future claim payments)

What will happen to the life company resilience test?

The life company resilience test will be replaced by the new ICA market risk component. The current resilience test is shown as a liability in the FSA returns. Under the new approach it will probably be included as a capital requirement instead.

Who will the Supplementary Capital Assessment ('SCA') apply to?

The SCA will applied by the FSA to firms that face special risks. This might be due to the characteristics of the business or to other specific risks such as mis-selling reviews.

It will also be used as a ’punishment’ on those firms perceived to have less than satisfactory controls or inadequate resources in key areas.

How will this change the amount of capital we must hold?

The CP is vague on detail and it is not possible to calculate the affect on any particular company. However it is clear that the solvency margin requirement will increase for all companies. The FSA expect that increases in solvency margins should be less than the amount of extra capital over and above the minimum amount that most companies already hold. This would mean that only a few companies would be required to hold extra capital as a direct result of the new regime.

What is not known however is what percentage of the new minimum will become the new unofficial ‘market standard’ required by credit rating agencies, IFAs and others. The most likely impact is that many companies will be required by these market forces to hold extra capital.

What is particularly disturbing about the new regime is that it will result in requirements above the EU minimum which will be implemented in other EU countries. This will give UK based firms a competitive disadvantage and provide an incentive for setting up insurance companies outside the UK.

What do we need to do now?

If you wish to influence the new capital adequacy standards then the deadline for submissions to the consultation paper is 31 August 2002.

If your company has possible weaknesses in the control, reporting, risk management or compliance areas then the CP gives another good reason to address these weaknesses now. This will give time for better controls to be demonstrably effective before the FSA decides whether your company should have a Supplementary Capital Assessment.

Otherwise there is little to do at this stage until a second CP with more detailed proposals is produced in 2003.

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