

**Solvency Modernization Initiative  
Country Comparison Analysis  
November 2009**

*(Note: Portions excerpted directly from FSA materials.)*

**Country: United Kingdom**

**1. Background Description**

The Financial Services Authority (FSA) regulates insurance firms in the UK. It is an independent non-governmental body that was given statutory powers by the Financial Services and Markets Act 2000. The FSA supervises most financial services markets, exchanges and firms, including banks, insurance companies, securities companies, stock exchanges, and insurance intermediaries.

**2. Solvency Regulation Description**

In response to a rash of insolvencies, the FSA developed a new solvency framework in the early 2000s (and implemented it in approximately 2004). This new framework contained new minimum capital requirements and introduced the Individual Capital Adequacy Standard (ICAS). In addition, greater incentives and requirements were imposed for firms to improve corporate governance and risk management. Audits of FSA life returns containing an actuarial review became required, and a new framework for reporting to the FSA was put in place. Below, emphasis is placed on the new capital requirements.

In summary, ICAS provides a framework for systematically considering the individual financial resources requirement of each insurer. In essence, the senior management of an insurer must carry out its own assessment of how much capital the firm needs given its business model and risk appetite. This capital amount is the Internal Capital Assessment (ICA) amount. The ICA is submitted to the FSA which makes its own assessment of whether this is an appropriate level of capital for the company. The FSA then issues Individual Capital Guidance (ICG) reflecting its assessment of how much capital is required to support an insurer's individual risk profile.

More specifically, the ICAS framework is a risk-based process that includes two key elements:

1. An Internal Capital Assessment (ICA) is submitted to address business and systems and control risks not adequately captured in the minimum capital requirements. This is a self assessment that is based on rules and guidance.

Requirements are that insurers:

(a) Maintain overall financial resources, including capital and liquid resources, adequate, both as to amount and quality, to ensure that there is no significant risk that their liabilities cannot be met as they fall due

(b) Have systems and procedures for assessing the financial resources that are sufficient to comply with the above

© For the purpose of determining the appropriate level of financial resources, identify the major sources of risk in each of certain categories

(d) For each of the major sources of risk identified, carry out stress tests and scenario analyses that are appropriate to the nature of the major sources of risks identified.

Through the ICA the firm should be able to demonstrate a level of solvency which can be compared to a 99.5% probability of remaining solvent over one year. And the ICA framework should be embedded in the firm's business.

The FSA provides some guidance about the ICA. The guidance comprises suggestions for the risks which firms should consider and how they might be assessed through stress tests, scenario analyses, or other models. It does not include any mandatory stress tests or quantitative factors to be adopted by firms. The belief is that providing prescriptive approaches would detract from the main purpose of the ICAS objectives (which is for the capital assessment to be tailored to each individual firm's particular risks). The FSA believes that the assessments are the only sensible way to incorporate a firm's future business plans, strategies and capital adequacy planning into the prudential regime.

2. A supervisory tool, Individual Capital Guidance (ICG), in which firms are given guidance on their ICA by the FSA, is provided. The approach taken in the review of the ICA differs according to risk area. In some risk areas, such as market, credit, and insurance risk, there is plenty of past experience data which is applicable market-wide because there are similarities in the nature of all firms' exposures. Therefore, the FSA can more readily apply benchmarks in considering applicability of stress tests, and increasingly, in judging the reasonableness of the answers.<sup>1</sup>

Operational risk requires a different approach. While different firms may be exposed to similar risks, the extent and range of possible impacts will differ from firm to firm. There is little data available to firms, and even assuming market-wide loss data is collected, there are material limitations for firms seeking to

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<sup>1</sup> If firms use benchmarks or professional guidance to set appropriate stress tests, the FSA will typically ask to see some justification. For example, firms might consider whether their UK equity investment strategy is sufficiently in line with the FTSE-All Share index for a benchmark stress test derived from that index to be appropriate.

apply such data in their own assessment. So there is therefore greater scope for management judgement in this area than in other risk areas. The FSA assessment focuses on whether the firm has used an appropriate approach to calculations and involved the people in the business in the best position to apply judgements (e.g., involved management to make informed judgements on assumptions to use). The more credible the approach, the more the FSA can rely on the answer.

In evaluating an insurer's ICA, the FSA is interested in the answer to three main questions:

Is there senior management engagement, including the Board?

How are the ICA principles and models being used for ongoing management purposes?

How are the ICA results used to influence risk management goals and prioritize activity?

*In May 2009, the Solvency II regime was adopted for use in the UK and will be implemented according to Solvency II's timetable. The FSA considers its ICAS system to be a mini version of Solvency II.*

### **3. Minimum Capital Standards**

#### *Life*

Two solvency tests were implemented for life insurers that have "with-profits" (participating) business:

- (1) A statutory test based on Solvency I and
- (2) A test based on realistic values for assets and liabilities (FSA test).

The non-profit business of a life insurer is subject to only one statutory test – the statutory test based on Solvency I. For the statutory test, the Minimum Capital Requirement (MCR) is the sum of the Resilience Capital Requirement and the Long Term Insurance Capital Requirement (LTICR).

The realistic approach applies only for the largest "with profit" firms (approx. 37 firms). For the realistic approach, a realistic estimate of liabilities is used and a (realistic) risk capital margin (RCM) is estimated. Two methods may be used to determine realistic reserves for with profit business: the asset share approach and the prospective or bonus reserve approach.

The risk capital margin should be the additional capital that a firm would need to hold to cover the effects of a relatively simple prescribed scenario. The FSA has set a scenario that prescribes market, credit and persistency stresses and that requires firms to recalculate the values of their "with profit" fund liabilities and their backing assets under the scenario. Where the fall in the value of the liabilities is less than the fall in the value

of the assets backing them, the net loss of value (or additional assets that would be required to maintain cover of the liabilities) would be the RCM. The overall confidence level associated with the scenario results is roughly 99.5% that the firm concerned will continue to have assets to cover its liabilities over a one-year period.

The realistic liabilities and risk capital margin are used in conjunction with statutory mathematical reserves to obtain an Enhanced Capital Requirement (ECR). The ECR is found as follows:

$$(\text{Realistic reserves} + \text{RCM}) - \text{Mathematical Reserves} = \text{ECR}$$

Conceptually, the ECR can be thought of as containing the Minimum Capital Requirement (i.e., the sum of the Resilience Capital Requirement and Long Term Insurance Capital Requirement) and a balancing factor referred to as With-Profit Insurance Capital Component (WPICC):

$$\text{ECR} = \text{MCR} + \text{WPICC} = (\text{Resilience Capital Requirement} + \text{Long Term Insurance Capital Requirement}) + \text{WPICC}.$$

Life firms are then required to hold a minimum amount of capital equal to the greater of the MCR or ECR.

### *Nonlife*

Nonlife insurers must hold the greater of

The Minimum Capital Requirement (MCR), which is the capital requirement set out in Solvency I. Firms are not permitted to fall below this level; and the

Enhanced Capital Requirement (ECR), in which a factor based approach is used, similar to risk-based capital. The formula bases charges on asset values, technical provisions, and premiums. Each capital charge is a percentage of the claims, premiums, or asset value specified. The charges for assets, technical provisions, and premiums are then added up. The amount derived is not meant to be a true risk-based capital standard. It is intended to be better than the EU's Solvency I in that it should reflect risk better.

#### **4. Enhanced Capital Requirement/Target Capital Requirement**

As indicated earlier, firms are required to submit ICAs to the FSA. These are reviewed for capital adequacy. In the course of doing this, the firm's overall operations are reviewed, including risk management and corporate governance processes. The ICA review process is summarized below.

- (a) Internal Planning. The FSA holds internal meetings to consider specific risks for the firm to be reviewed and to agree on timetables for the review.
- (b) Submission Request for ICA. A submission request letter is sent to the firm by the FSA that is tailored to the firm's specific risks and circumstances. The FSA Supervisor assigned to the firm will discuss the information request with the firm after they have received the letter. Normally three months' notice is given for the ICA.
- (c) Initial Review. Internal FSA review of the ICA materials submitted is undertaken along with other information that the FSA has.
- (d) Written Questions/Discussion with Firm. Based on the Initial Review, the FSA review team prepares a number of questions for the firm. The review process may include face-to-face discussions with the firm to discuss and explore areas of concern or to provide further background and evidence. If an on-site visit is scheduled the issues that the FSA wants to focus upon are submitted in advance.
- (e) FSA Initial View. This is the second stage of the internal FSA review. The FSA may have further discussions with the firm, usually by telephone or email. The end result is the production of an internal report known as a 'Panel Pack.' This sets out the review team's conclusions and recommendations and forms the basis of the discussions with the panel of experts (described below).
- (f) Discuss Findings with Firm. Before the panel meeting, the FSA review team communicates the key conclusions to the firm's senior management, giving the firm an opportunity to have its comments taken into account by the ICG panel.
- (g) FSA Panel Process. The review team presents the conclusions and recommendations to a panel for review and moderation. The panel consists of at least one head of an FSA department, one independent manager (i.e., one not responsible for any aspect of the supervision of the firm) and one actuary. Depending on the issues involved, this may be supplemented by a policy adviser or risk review specialist. The panel considers the key issues for each firm within an industry wide context to ensure broad consistency.
- (h) Formal Notification. Following the internal validation by the panel, the supervisory team will write to the board of the firm providing both quantitative and qualitative feedback on the results of the FSA assessment. This letter notifies the firm of the ICG considered appropriate. It includes reasons for any capital add-ons and identifies, where appropriate, what actions the firm can take to reduce the level of add-ons. The goal is to provide the ICG within 6 months of receipt of the ICA.

For nonlife firms and life insurers that are not "with profit", the ICG is stated in terms of the ECR. The FSA considers that the benefits of simplicity of measurement and monitoring, consistency between firms, and less intensive supervisory scrutiny of a model's construction and assumptions outweigh any benefits of expressing the ICG in terms of firms' own ICAs.

When designing the ICAS regime, the FSA did not expect to be able to base the life ICG directly on the firm's own capital model. However complexities associated with the twin peaks approach and the life business in general caused problems. Therefore, in practice, for life firms, the FSA is now inclined to express ICG in terms of the firm's ICA results. This means that the FSA needs to subject models to a significantly greater degree of scrutiny than originally planned.

## **5. Peer Review**

A life insurer's provisions for liabilities to policyholders in the annual return must be audited, and the auditor must appoint an independent reviewing actuary to advise him/her on their valuation.

For life insurers that have with-profits liabilities, the realistic peak (within the twin peaks approach) is within the scope of the audit and reviewing actuary's and directors' reports.

The auditor is required to appoint an independent actuary who will review the firm's actuarial investigation as to the appropriate provisioning of its liabilities (and so, its valuation reports). The reviewing actuary reports directly and privately to the auditor, giving his or her view on the reasonableness of the valuation of liabilities by the firm, the methods used, and the economic, market and actuarial assumptions on which the calculations are based. The audit report will explicitly state that the auditor has been advised by a suitably experienced and qualified actuary, and that all relevant associated professional guidelines have been complied with.

Actuarial work carried out as part of the audit will be subject to potential review by the Audit Inspection Unit, operating under the Financial Reporting Council.<sup>2</sup>

Finally, as noted in the discussion of the ICAS process, a panel of experts reviews the supervisory team's recommendation for any ICG.

## **6. Reporting**

The Annual Return (or annual financial report), has detailed information on premiums and claims for each line of business. The Annual Return consists of the following set of documents:

Audited financial statements, including  
Consolidated accounts prepared according to IFRS  
Parent company accounts prepared in accordance with the national law of  
the EEA State in which the parent company is incorporated.

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<sup>2</sup> The audits of all UK incorporated companies with listed securities and other entities in whose financial condition there is considered to be a major public interest are within the scope of the Financial Report Council's Audit Inspection Unit's (AIU) work.

A management or directors' report, including a(n)  
Fair review of insurer's business  
Description of principal risks and uncertainties facing the insurer  
Indication of any important events that have occurred since the end of  
the financial year.

Responsibility statements must be made by the persons responsible within the insurer. For each person making a responsibility statement, the statement must attest that to the best of his/her knowledge

- (a) the financial statements, prepared in accordance with the applicable set of accounting standards, give a true and fair view of the assets, liabilities, financial position, and profit or loss of the insurer and the undertakings included in the consolidation taken as a whole; and
- (b) the management report includes a fair review of the development and performance of the business and the position of the insurer and the undertakings included in the consolidation taken as a whole, together with a description of the principal risks and uncertainties that they face.

## **8. On-Site Examinations**

Firms with a high impact rating from the ARROW analysis will receive an on-site visit.

An on-site visit may also be part of the ICAS process.

## **9. Off-site Analysis**

When performing an evaluation for an ICG, the FSA draws upon the review of the firm's ICA along with the Arrow risk assessment and any other issues it is aware of from its day to day supervision. ARROW stands for Advanced Risk Response Operating frameWork. The objectives of Arrow are to:

- Help FSA meet its statutory objectives by focusing on key risks
- Influence resource allocation to make efficient and effective use of limited resources
- Use appropriate regulatory tools to deal with risks or issues
- Undertake proportionally more work on a thematic (or cross-sectional) basis

The ARROW framework describes how the FSA assesses insurer risk. Basically, insurer risk is assessed by the impact and probability of failure. An insurer's impact rating depends on the size of the firm, and is expressed as high, medium high, medium low, or low. The size of the firm is measured by premium income, assets/liabilities, funds under management, annual turnover, or other similar measures, depending on the firm's sector.

The probability assessment is performed on a firm by firm basis, by considering each element in a matrix of risks. The thoroughness of the probability assessment depends on the impact rating of the firm. Low impact firms won't be assessed individually; high impact firms will be assessed in great detail, with visits from the FSA; those in the middle will get desk-based assessments.

After performing the probability assessment, the FSA develops a risk mitigation program (RMP) for the firm. The RMP uses a selection of regulatory tools intended to reduce the risks that have been flagged as requiring action. Usually, this means that the firm has to take some action (e.g., produce and implement a plan for introducing a risk management process).

## **10. Definition of Capital**

Two categories, or tiers, of capital are applicable to insurers – Tier 1 and Tier 2. Both of these general categories are further subdivided. Tier 1 is subdivided into three categories:

Core Tier 1 (e.g., ordinary shares, member contributions, and audited reserves),  
Non-ordinary shares (e.g., perpetual noncumulative preferred shares), and  
Innovative Tier 1 (e.g., capital instruments and innovative instruments).

Limits exist as to how much of Non-ordinary shares and Innovative Tier 1 capital can be included in the capital base.

Lower tiers of capital (e.g., long-term or perpetual subordinated debt) are either subject to limits or require a waiver to be eligible for inclusion in a firm's capital resources.