

# Enhanced Capital Requirements

Catherine Cresswell



[WWW.WATSONWYATT.COM](http://WWW.WATSONWYATT.COM)



# Agenda

---

- Regulatory background
- Capital requirements ECR and ICA
- What it means £
- What it means – communication and analysis
- What's on the horizon
- Questions

Background

ECR & ICA

£££

Uwr role

and Next

Questions





# Agenda

---

- Regulatory background
- Capital requirements ECR and ICA
- What it means £
- What it means – communication and analysis
- What's on the horizon
- Questions

Background

ECR & ICA

£££

Uwr role

and Next

Questions





# FSA Mantra

---

- Risk Based Supervision
- FSA Focus
  - How much risk is a company running
  - How much capital does it need



## **FSA Modus operandi**

---

- **Responsibility of company management to know**
  - How much risk is a company running
  - How much capital does it need
- **FSA checks company's doing this appropriately**



# FSA Rules

---

## Principle 4

*A firm must maintain adequate financial resources*

Also, Rule PRU 1.2.22 - **Always**

*A firm must at all times maintain overall financial resources, including capital resources and liquidity resources, which are adequate, both as to amount and quality, to ensure that there is no significant risk that its liabilities cannot be met as they fall due.*



## **A company must:**

---

### **Know how much capital it needs**

Rule: PRU 1.2.26

*A firm must carry out regular assessments of the adequacy of its financial resources using processes and systems which comply with PRU 1.2.27.*



# A company must:

---

## Identify its major sources of risk

Rule: PRU 1.2.31

*The processes and systems required by PRU 1.2.26 must enable the firm to identify the major sources of risk to its ability to meet its liabilities as they fall due, including the major sources of risk in each of the following categories:*

- (1) credit risk;*
- (2 ) market risk;*
- (3) liquidity risk;*
- (4) operational risk; and*
- (5) insurance risk.*





## **A company must:**

---

**Know how it intends to *deal* with the risks it faces**

Rule: PRU 1.2.33

*The processes and systems required by PRU 1.2.26R must enable the firm to carry out an assessment of how it intends to deal with each of the major sources of risk identified in accordance with PRU 1.2.31*



## A company must:

---

### Use Stress and Scenario testing to assess its capital needs

Rule: PRU 1.2.35

*For each of the major sources of risk identified in accordance with PRU 1.2.31, the firm must carry out stress tests and scenario analyses that are appropriate to the nature of those major sources of risk, as part of which the firm must: (1) take reasonable steps to identify an appropriate range of realistic adverse circumstances and events in which the risk identified crystallises; and (2) estimate the financial resources the firm would need in each of the circumstances and events considered in order to be able to meet its liabilities as they fall due.*



# A company must:

---

## Document its assessment

Rule: PRU 1.2.37

*A firm must make a written record of its assessment of the adequacy of its financial resources, including:*

- (1) the major sources of risk identified in accordance with PRU 1.2.31;*
- (2) how it intends to deal with those risks; and*
- (3) details of the stress tests and scenario analyses carried out and the resulting financial resources estimated to be required in accordance with PRU 1.2.35.*

## And Keep it

Rule: PRU 1.2.37 *A firm must retain the records of its assessment of the adequacy of its financial resources for at least three years.*





# A company must:

---

## Document its assessment

Rule: PRU 1.2.37

*A firm must make a written record of its assessment of the adequacy of its financial resources, including:*

- (1) the major sources of risk identified in accordance with PRU 1.2.31;*
- (2) how it intends to deal with those risks; and*
- (3) details of the stress tests and scenario analyses carried out and the resulting financial resources estimated to be required in accordance with PRU 1.2.35.*

## And Keep it

Rule: PRU 1.2.37 *A firm must retain the records of its assessment of the adequacy of its financial resources for at least three years.*



# **A company must:**

---

## **Principle 11**

**Relations with regulators** A firm must deal with its regulators in an open and cooperative way, and must disclose to the FSA appropriately anything relating to the firm of which the FSA would reasonably expect notice.



# **FSA Rules**

---

## **Companies must:**

**Assess the risks they face**

**Work out how much capital they need**

**Hold at least as that much capital**

**Leave an audit trail the FSA can check**



# **Last and least....EU Rules**

---

**Companies must:  
have EU solvency margin**











# Agenda

---

- Regulatory background
- Capital requirements ECR and ICA
- What it means £
- What it means – communication and analysis
- What's on the horizon
- Questions

Background

ECR &ICA

£££

Uwr role

and Next

Questions





# FSA Tools

---

 ICAs

 ECRs

 [EU minimum]

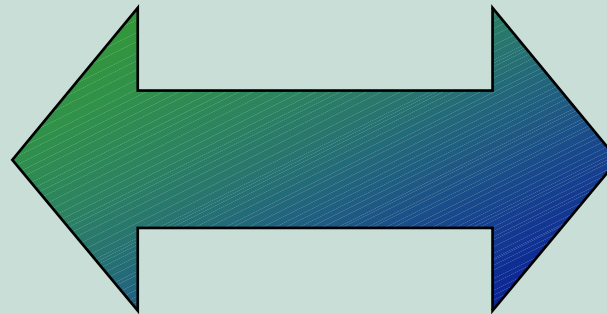
 **ICAs that really count**



# ECR

---

**Make  
it  
fit**



**Keep  
it  
simple**

**Lots of components**

**Assets included**

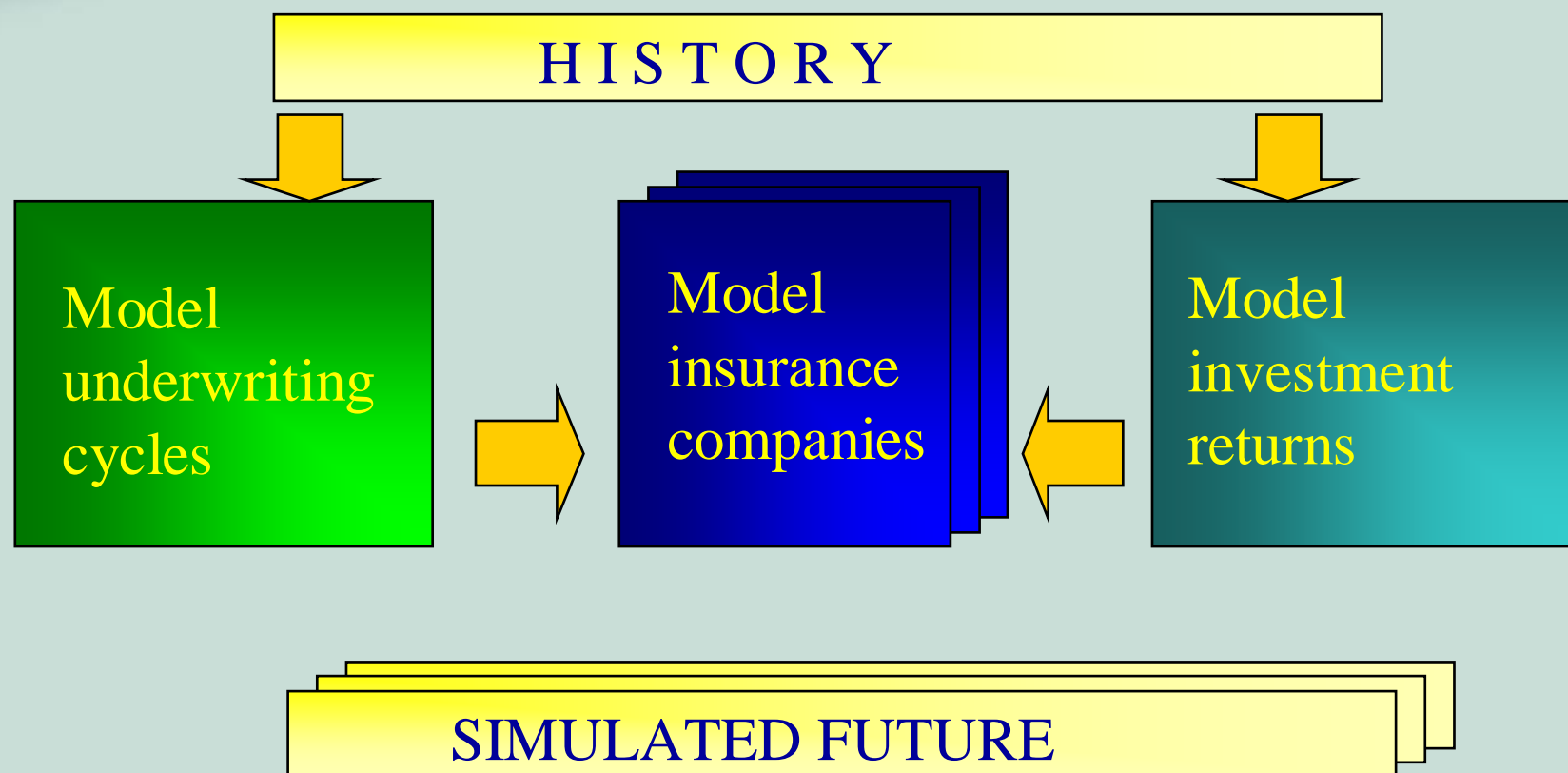
**Simple structure to  
formula, 3 blocks added  
together, each block  
weighted sum of  
components**

**Diversification “hidden”  
in calibration algorithm**



# Putting the ECR together

---





# Putting the ECR together

---



SIMULATED FUTURE

Capital  
needed

Model  
insurance  
companies

ECR FACTORS

FIT



# ECR

---



- Fit based on £££'s
- Will fit large well diversified companies best
- Smaller companies may well need much more capital
- Specialist companies may well need more / less capital



# Regulatory tools

---

## ECR

-  Formulaic assessment based on balance sheet items and premiums written
-  Quick and Dirty – but much better than EU Required minimum margin

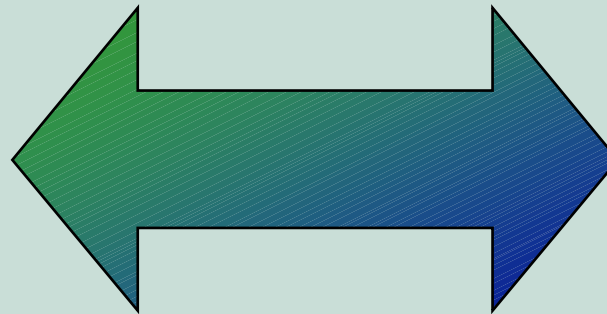




# ECR

---

**Make  
it  
fit**



**Keep  
it  
simple**

**Lots of components**

**Assets included**

**Simple structure to  
formula, 3 blocks added  
together, each block  
weighted sum of  
components**

**Diversification “hidden”  
in calibration algorithm**



# ECR

---

Assets  
Charge

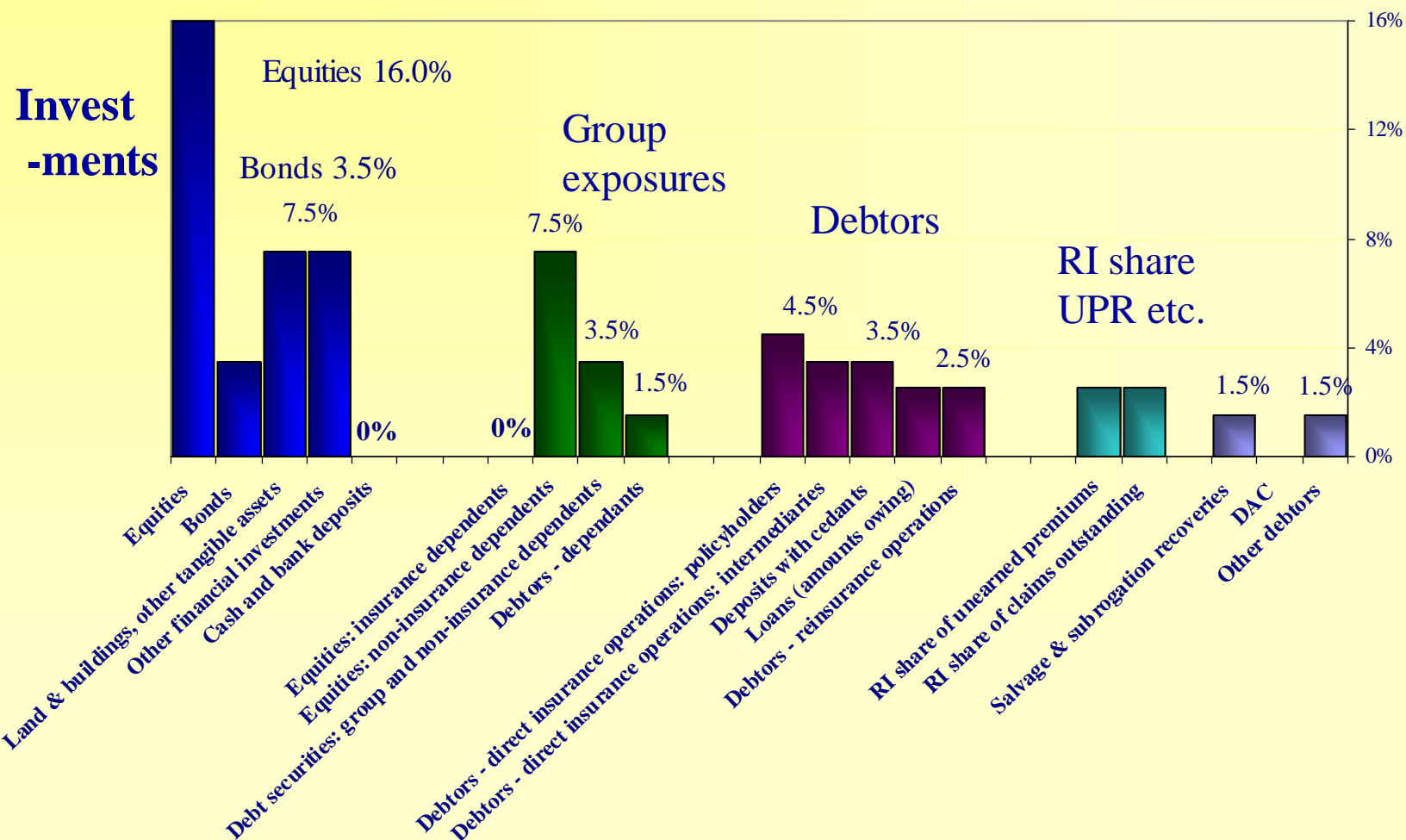
+

Premium  
Charge

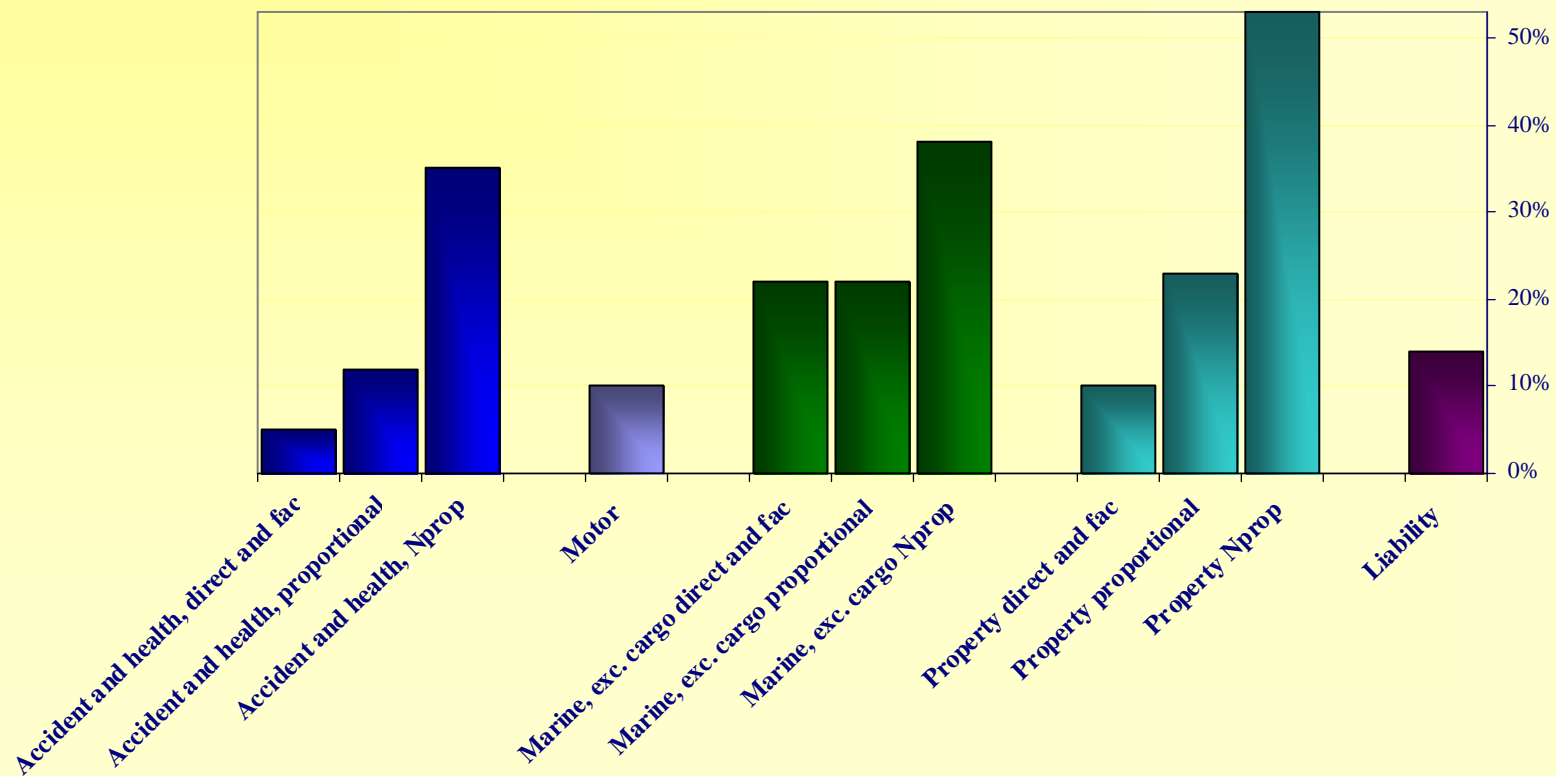
+

Technical  
Reserves  
Charge

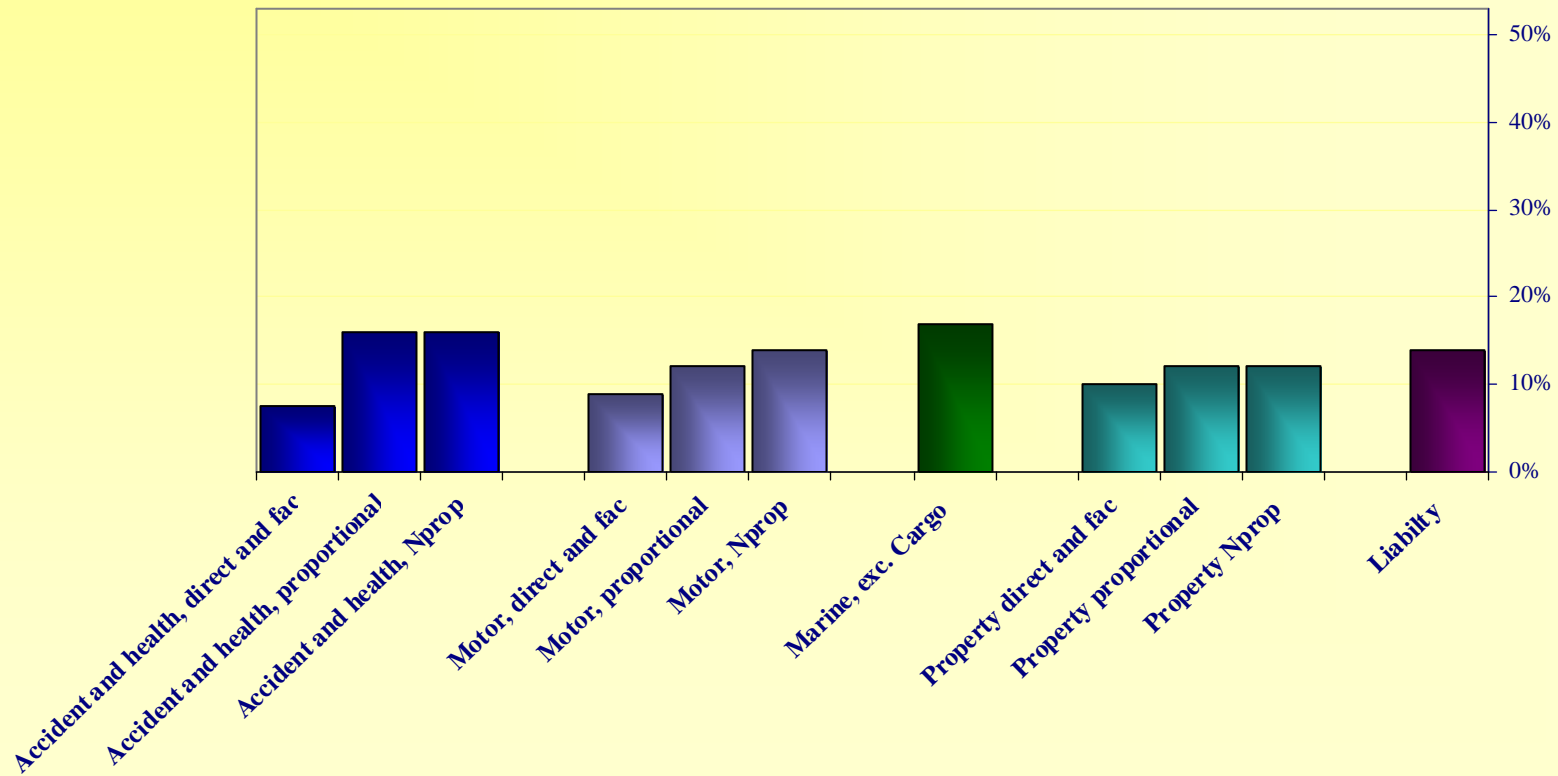
## ECR: Asset charges to apply to amount - £'s of each asset category held (FSA valuation basis)



## ECR: premium charges to apply to NWP amount - £'s for some classes



## ECR: technical provisions charges for some classes





# Agenda

---

- Regulatory background
- Capital requirements ECR and ICA
- What it means £
- What it means – communication and analysis
- What's on the horizon
- Questions

Background

ECR &ICA

£££

Uwr role

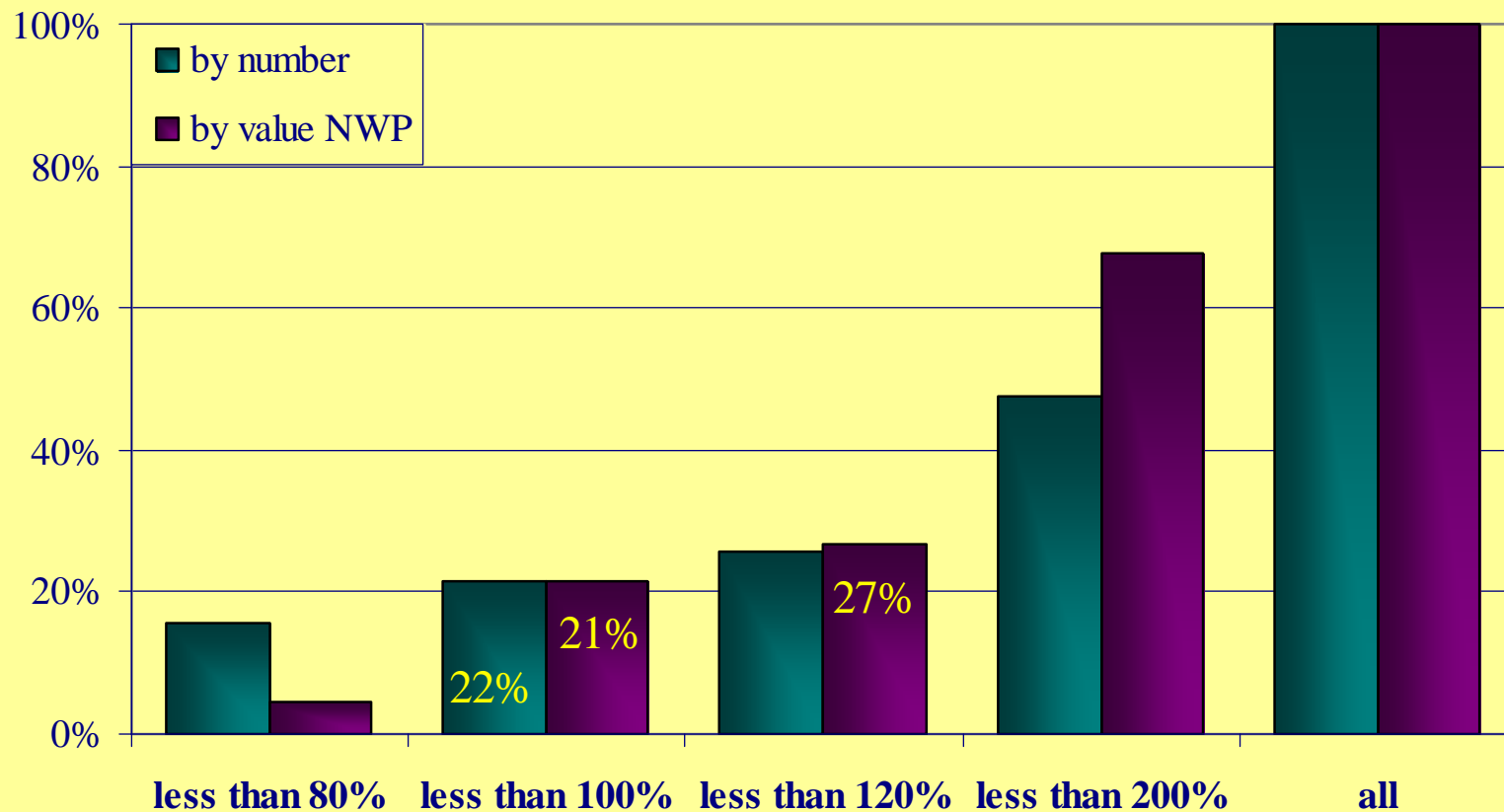
and Next

Questions

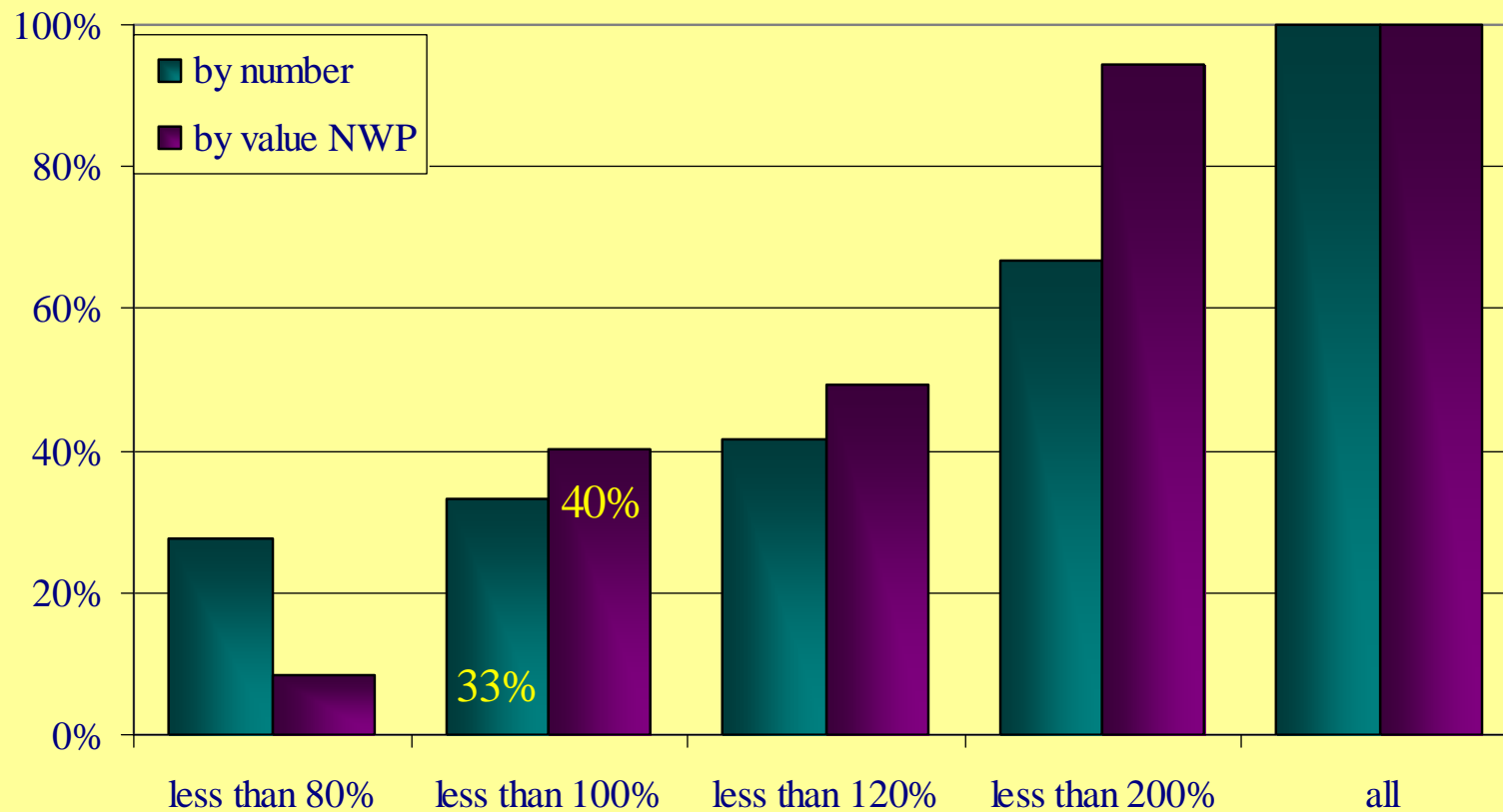


## ~ All companies writing business in 2004

(2004 FSA return data - excludes Lloyd's)

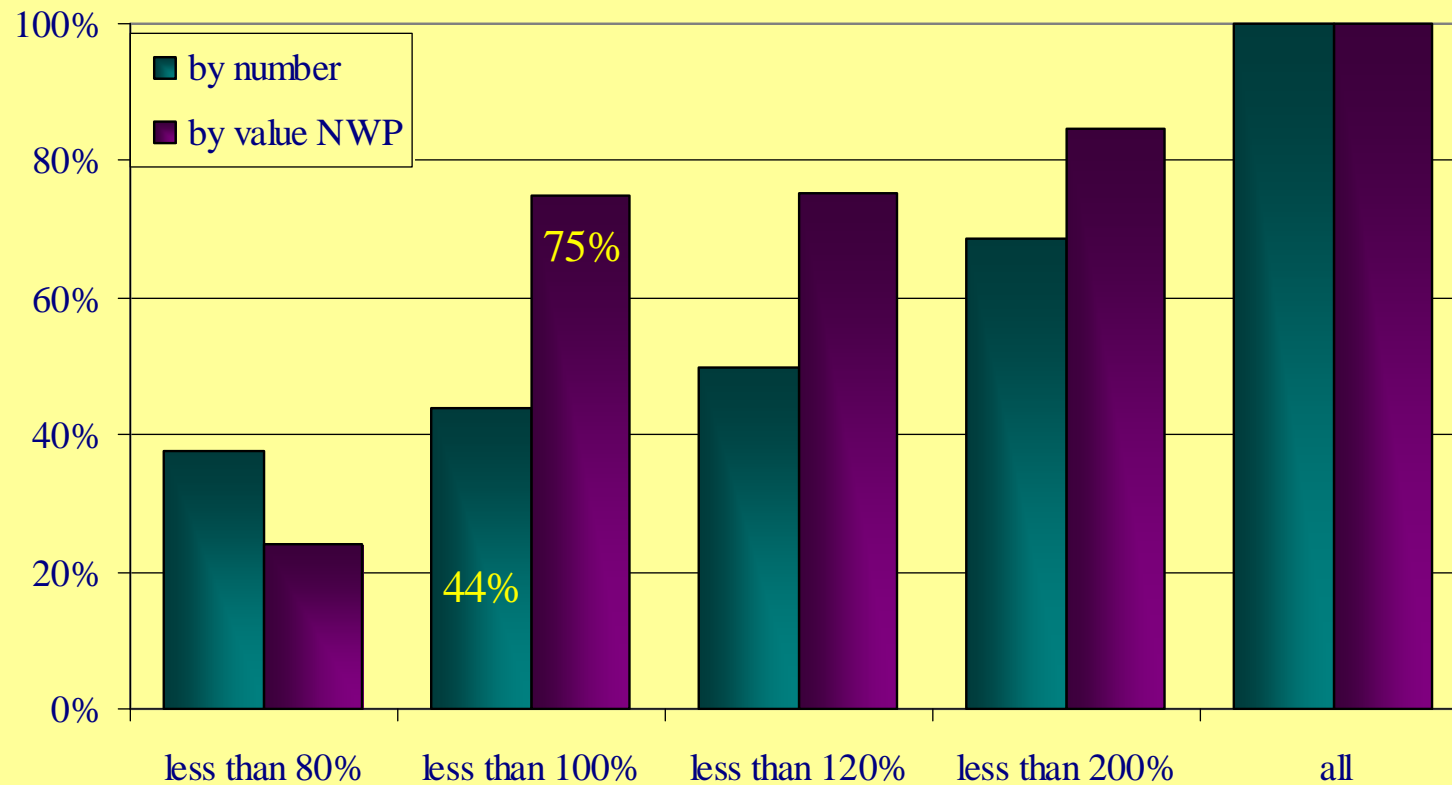


**Companies writing at least *a third* of their business in non marine liability lines (2004 FSA returns data - excludes Lloyd's)**

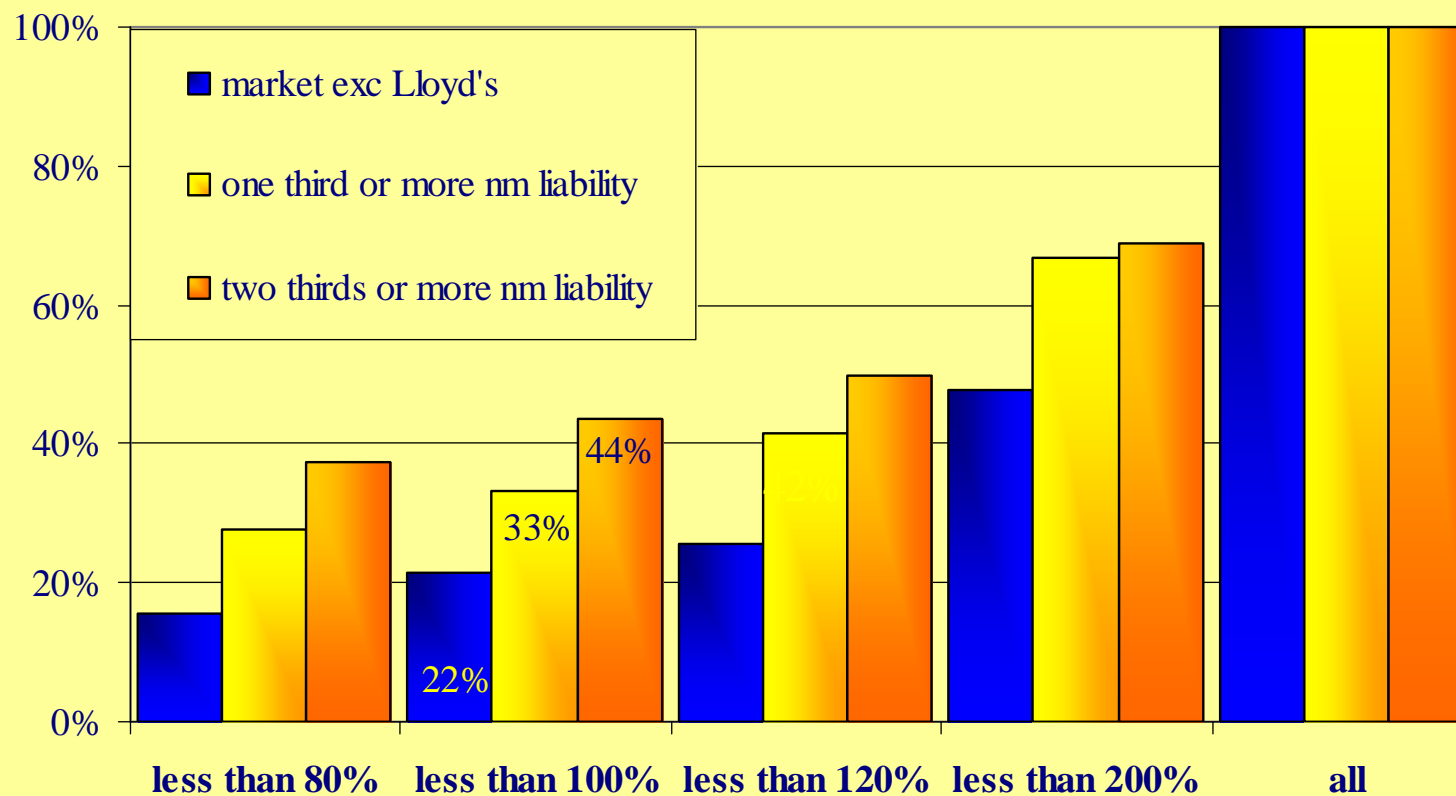




**Companies writing at least *two thirds* of their business in non marine liability lines (2004 FSA return data - excludes Lloyd's)**



### All v Liability in 2004 (2004 FSA return data - excludes Lloyd's)





## **Why?**

---

- **Size of reserves**
- **Longer tail means many more years payments in reserves**
- **So charge applied to a much bigger number...**



# FSA Tools

---

 ICAs

 ECRs

 [EU minimum]

 **ICAs that really count**

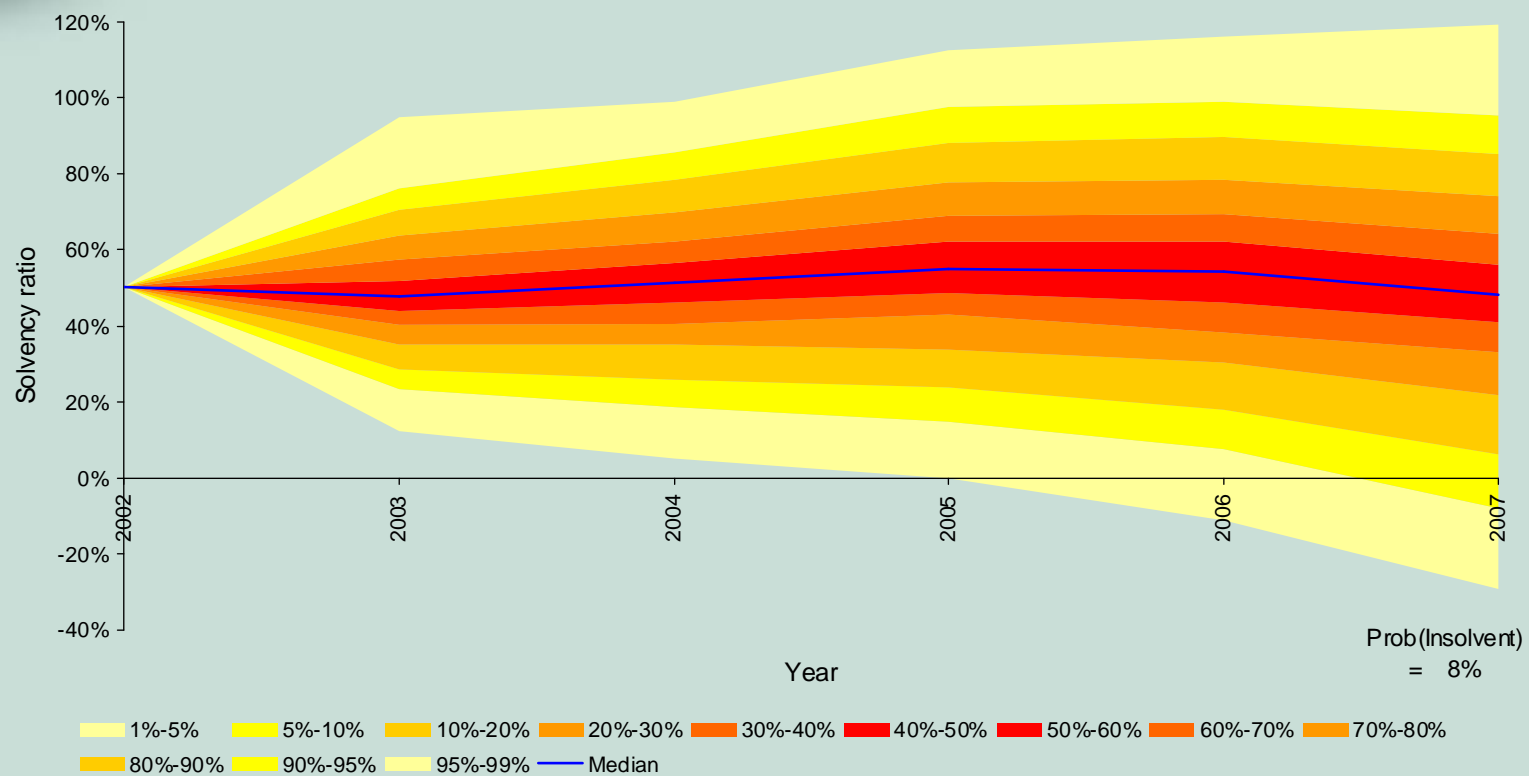


# ICAs

---



# ICAs





# ICAs

---



# Regulatory tools



 Company's own assessment



FSA review, nudge company  
towards acceptable assessment

Acceptable assessment  
 $ICG = ICA$








# Big Stick

---

 ICG

 FSA's assessment  
ICG > ICA



# Agenda

---

- Regulatory background
- Capital requirements ECR and ICA
- What it means £
- What it means – communication and analysis
- What's on the horizon
- Questions

Background

ECR & ICA

£££

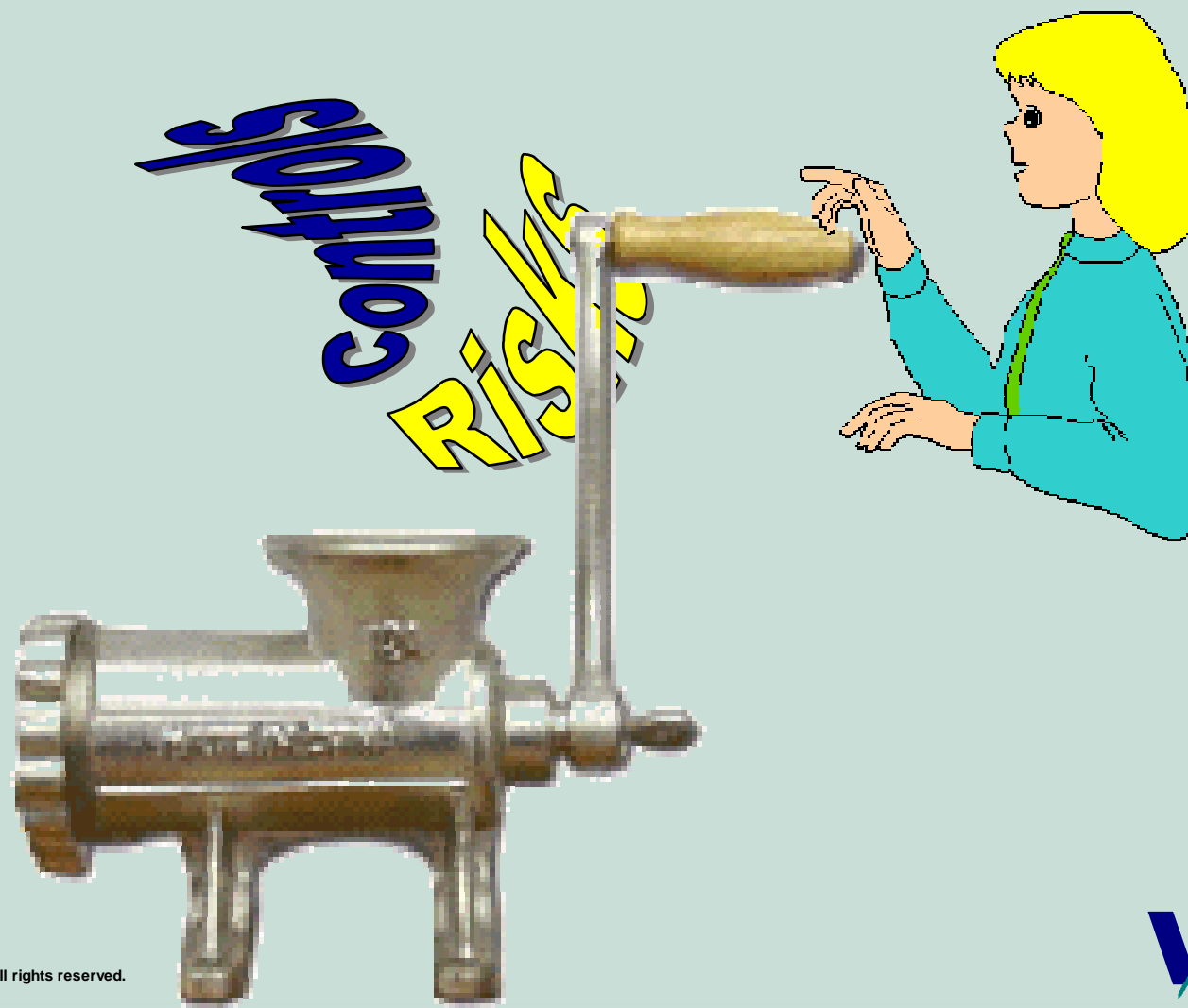
**Uwr role**

and Next

Questions



# ICAs





## **Communicate with the boffin!**

- (S)he is modelling the underwriters' prospective risk.....
- Make sure changes to portfolio are reflected in model
- Make sure significant risk reduction features are modelled



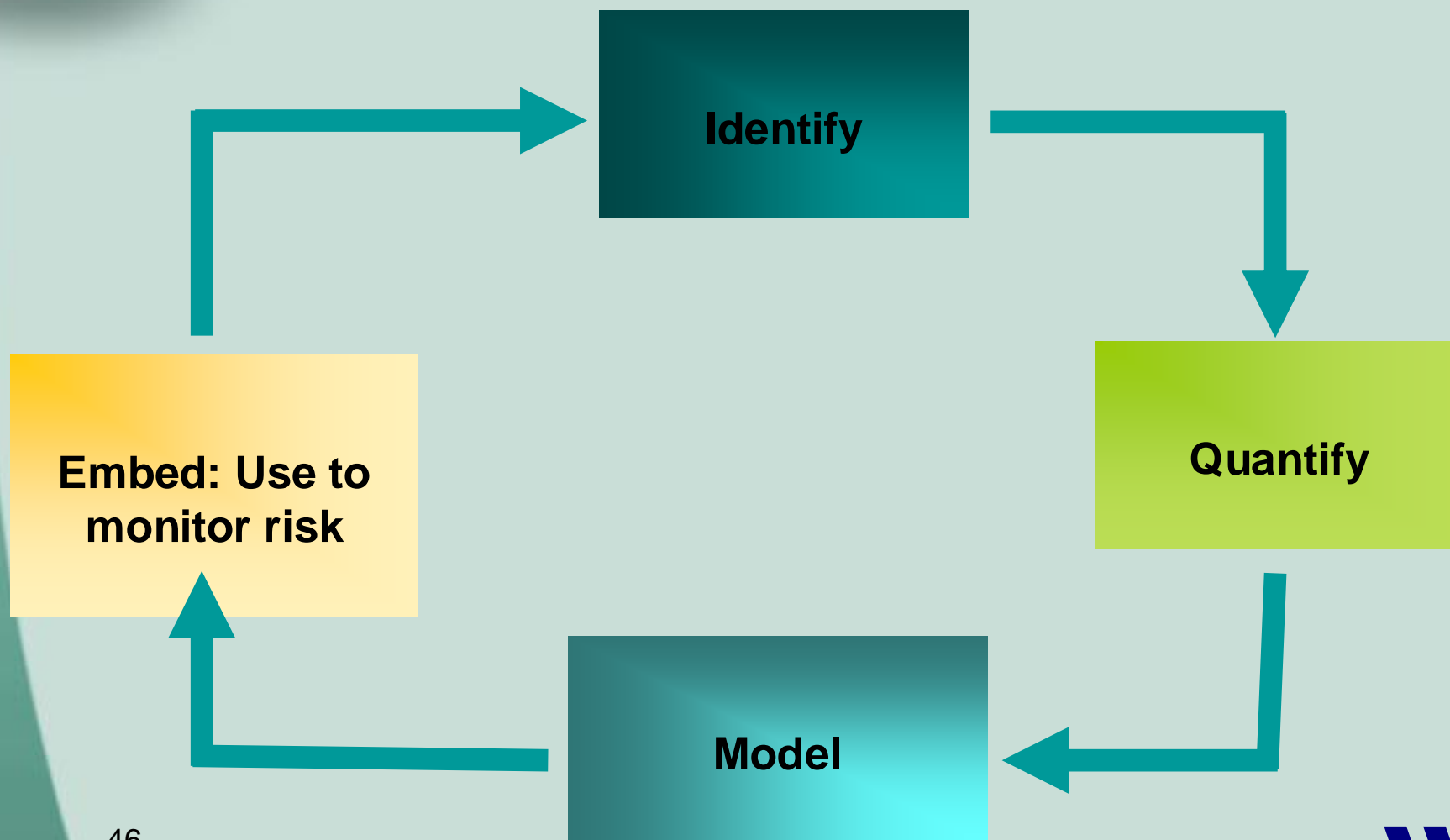
# **Communicate with the boffin!**

- Changes in portfolio
- Swing rated business
- Fac RI
- Commutation clauses
- Etc....



# ICA Process

---





Specialist

ICAs  
Examined in  
detail

ICAs  
benchmarked  
against ECRs

Normal

Small

Large



# Agenda

---

- Regulatory background
- Capital requirements ECR and ICA
- What it means £
- What it means – communication and analysis
- What's on the horizon
- Questions

Background

ECR &ICA

£££

Uwr role

and Next

Questions





## **European Solvency II**

---

- Assess “overall solvency”
- Based on Basle 2-type three-pillar structure
- Risk-oriented approach
- Increase harmonisation of supervisory methods
- Efficient supervision of insurance groups
- Consistency between financial sectors
- Develop parallel to international developments





## **Current position – Solvency II**

- Implementation – 2010 – final date???



# Agenda

---

- Regulatory background
- Capital requirements ECR and ICA
- What it means £
- What it means – communication and analysis
- What's on the horizon
- Questions

Background

ECR &ICA

£££

Uwr role

and Next

Questions