

Solvency II: a partial Impact Assessment

June 2008



HM TREASURY



HM TREASURY

**Solvency II:
a partial Impact Assessment**

June 2008

© Crown copyright 2008

The text in this document (excluding the Royal Coat of Arms and departmental logos) may be reproduced free of charge in any format or medium providing that it is reproduced accurately and not used in a misleading context. The material must be acknowledged as Crown copyright and the title of the document specified.

Any enquiries relating to the copyright in this document should be sent to:

Office of Public Sector Information
Information Policy Team
St Clements House
2-16 Colegate
Norwich
NR3 1BQ

Fax: 01603 723000

e-mail: HMSOlicensing@opsi.x.gsi.gov.uk

HM Treasury contacts

This document can be found in full on our website at:

hm-treasury.gov.uk

If you require this information in another language, format or have general enquiries about HM Treasury and its work, contact:

Correspondence and Enquiry Unit
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Tel: 020 7270 4558

Fax: 020 7270 4861

E-mail: public.enquiries@hm-treasury.gov.uk

Printed on 100% recycled paper.

When you have finished with it please recycle it again.

ISBN 978-1-84532-466

PU584

CONTENTS

		Page
Chapter 1	Summary of costs and benefits in this report	3
Chapter 2	Prudential supervision in the insurance sector	5
Chapter 3	Estimates of costs of implementing Solvency II in the UK	9
Chapter 4	Estimate of benefits arising from implementing Solvency II in the UK	23
Annex A	Incremental capital	31

SUMMARY OF COSTS AND BENEFITS IN THIS REPORT

1.1 The implementation of Solvency II in the UK will lead to tangible benefits for insurers and reinsurers, their customers, and the economy in general. It will also impose incremental costs on firms as they adapt to the new prudential regime. In the UK, these costs will be minimised due to the introduction of a risk based regime known as ICAS (Individual Capital Adequacy Standard)¹, which implemented prudential requirements similar to the proposed Solvency II standard.

1.2 Overall, we consider that Solvency II will have a net benefit in the UK. This is based on our assessment of the net quantifiable benefit to the UK economy of **£97m** on an ongoing basis, which is summarised in the table below:

Table 1: net benefits of Solvency II for the UK

	£m
Ongoing benefits	329.7
Ongoing costs	(233.1)
NET BENEFITS	96.6

Source: HM Treasury calculations based on data in this report

1.3 We examine these costs and benefits in more detail in this Impact Assessment. Our calculations take the ICAS regime as a benchmark. Therefore, any costs and benefits are those incremental to the current prudential regime in the UK. The report is structured as follows: Chapter 2 describes the rationale of prudential regulation in the insurance sector, along with a brief outline of the Solvency II project and the objective of undertaking this Impact Assessment; Chapter 3 sets out our estimates of the incremental costs we think insurers will face; and Chapter 4 describes the benefits to UK firms, policyholders, and the economy in general.

¹ ICAS was implemented by the Financial Services Authority in 2004. It is referred to several times in this report and explained in more detail in Chapter 2.

2

PRUDENTIAL SUPERVISION IN THE INSURANCE SECTOR

2.1 Insurance and reinsurance has a considerable impact on the UK's economy. There are around 1,050 UK firms¹ authorised to conduct insurance business and last year the UK industry generated approximately £227 billion of premiums, corresponding to 16.5% of GDP². Across Europe as a whole there are around 5,000 firms³ who in 2006 generated approximately £806 billion of annual premiums⁴. Insurers and reinsurers provide vital financial services to both individual retail customers and wholesale corporations by providing protection against loss from future events. The UK insurance industry employs around 324,000 people, approximately one-third of all jobs in the financial services sector⁵.

Rationale for prudential supervision

2.2 Insurance and reinsurance, like other financial services, is a regulated activity and is subject to supervision in the UK by the Financial Services Authority (FSA), both in terms of prudential oversight and conduct of business requirements. In retail insurance markets it is extremely difficult for individual customers to assess the financial position of an insurer. Supervision mitigates the risk of consumer detriment which this asymmetry of information would otherwise lead to. In the wholesale insurance sector it is far more likely that insurers' counter-parties are capable of assessing financial strength; nevertheless the potential risks to the stability of the insurance and reinsurance sector combined with possible contagion to other financial sectors supplies a robust rationale for prudential supervision.

2.3 Prudential supervision takes the form of quantitative capital requirements and qualitative rules on risk management and disclosure. Solvency II is concerned with prudential supervision and not conduct of business (which is governed by other legislation). The objective of prudential supervision is to ensure that insurers are sufficiently well capitalised, and have appropriately robust controls and procedures in place, to guarantee a certain degree of protection to policyholders. To be most effective such regulation should include the following characteristics: it should be principles-based rather than comprised of detailed rules; the restrictions it imposes on firms should be proportionate to the benefits gained; it should encourage innovation with regard to the activity it regulates; and it should facilitate competition between undertakings.

2.4 The current European prudential regulatory framework (Solvency I) dates back to the 1970s. These requirements are outdated, not based on economic principles, and are widely thought to be unsuitable for the modern global business of insurance. In the UK, the FSA implemented a new principles-based economic prudential regime for insurers with the introduction of ICAS in 2004, which supplements the current Directive requirements. The FSA requirements are based in a large part on the new Basel II framework for the banking sector. Further developments in the prudential supervision of insurance are being undertaken at international level by the International

¹ Source: ABI UK Insurance – Key Facts publication 2006.

² Source: Swiss Re Sigma No 4/2007. Total premium volume; excludes cross-boarder business.

³ Source: CEA topography of EU25 insurance market (January 2007).

⁴ Source: Swiss Re Sigma No 4/2007. Converted from USD to GBP using an average exchange rate for 2006 of 1 GBP = 1.8425 USD.

⁵ Source: ABI UK Insurance – Key Facts publication 2006.

Association of Insurance Supervisors (IAIS), which is in the process of formulating a set of global standards for the risk-based supervision of insurers and reinsurers.

The Solvency II project

2.5 Solvency II is a prudential framework for the supervision of insurers and reinsurers operating in the EU. The European Commission has stated⁶ that the project has the following broad objectives:

- Deepen the integration of the EU insurance market;
- Enhance the protection of policyholders and beneficiaries;
- Improve the international competitiveness of EU insurers and reinsurers; and
- Promote better regulation in insurance financial services.

2.6 Solvency II is based on a three-pillar approach used in the Basel II banking accord. Pillar 1 contains quantitative capital requirements and the eligibility criteria for the funds insurers can use to meet those requirements, as well as principles for the investments of assets and the valuation of liabilities. Pillar 2 covers qualitative requirements on firms' risk management procedures and the requirements for supervisory authorities in conducting supervision. Pillar 3 includes principles for disclosure by firms to both supervisors and the public. All these requirements apply to both solo entities and insurance groups.

2.7 The Solvency II project is being developed under the Lamfalussy arrangements⁷ which divide European legislation into four separate levels. On 19th July the Commission published its proposal for a Solvency II directive: this is the level 1 text which consolidates the existing EU insurance directives and contains high-level principles underlying the new Solvency II prudential framework. Level 2 implementing measures will then be put in place to further develop the technical detail underlying the overall principles and which will be subject to future reviews. Future convergence of supervisory practices across the Member States will be achieved at level 3, and any necessary enforcement procedures against Member States that fail to properly implement the directive will be carried out under level 4. Solvency II is intended for implementation in 2012.

2.8 Solvency II has entered the co-decision stage for European legislation, with the Commission's proposal being debated in the European Parliament and the Council of Ministers. The costs and benefits outlined below are therefore based on the current level 1 text as proposed by the Commission and the current expectations of level 2 measures that will be in place at implementation⁸.

Objective of this Impact Assessment

2.9 The objective of this Impact Assessment is to provide a preliminary examination of the likely costs and benefits to UK insurers from the implementation of the Solvency II Directive. Given that the level 1 Directive has yet to be agreed, and the level 2 measures are still under development, the analysis in this report represents an initial

⁶ Source: European Commission Solvency II Impact Assessment Report SEC(2007)871

⁷ HM Treasury and FSA have recently published a consultation document setting out the UK's view of how the Lamfalussy arrangements should be modified in the light of examples of their operation to date. It is available at http://www.hm-treasury.gov.uk/media/4/0/fin_lamfalussy071107.pdf

⁸ These are being developed by the European Commission, on the basis of advice from the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS)

assessment only of the costs and benefits of Solvency II in the UK. HM Treasury intends to update this Impact Assessment from time to time to take account of additional information as the proposal evolves.

2.10 The insurance and reinsurance sector in the UK is comprised of a wide variety of firms. As the costs and benefits will affect firms in different ways, we have considered in our analysis the different types of insurers and reinsurers which operate in the UK market. These include both life and non-life (general) insurers and reinsurers, of all sizes, as well as insurance and reinsurance groups.

A range of policy options

2.11 In its impact assessment published alongside the Directive, the Commission considered four options for the review of prudential insurance and reinsurance in the EU:

- **Option 1:** no change from current requirements of the existing EU insurance directives (Solvency I).
- **Option 2:** to make relatively minor updates to the existing Solvency I directives.
- **Option 3:** wait for an international solvency solution to be developed by the International Association of Insurance Supervisors (IAIS).
- **Option 4:** develop a new EU solvency system

2.12 Due to the structural problems inherent in the Solvency I regime, neither option 1 or 2 was considered sufficient in addressing the current weakness of the EU prudential supervisory approach. Solvency I is generally considered to be out of date and no longer effective as a basis for supervising a global insurance industry. Although option 3 would allow for the greatest consistency with international developments, the timetable of the IAIS in formulating these standards would mean that the fundamental problems of the EU regime would remain in the medium to long term. It was therefore felt that a full review of the solvency system (option 4) was the most appropriate choice.

Implementing Solvency II in the UK

2.13 As the FSA has already implemented a risk-based prudential framework for insurers which is broadly similar in design to Solvency II, the balance of cost/benefit considerations for the UK is different from most Member States. Many of the costs of Solvency II implementation will have already been borne by UK insurers. The FSA's ICAS framework provides an appropriately high degree of policyholder protection that is already in line with best practice in prudential supervision of insurance and reinsurance, and so equally many of the principal benefits of Solvency II have already been gained in the UK.

2.14 However, since the prudential requirements imposed by the FSA on UK insurers are significantly more demanding than in most other Member States (where the regulations are generally more closely based on the existing Solvency I directives) the UK industry is at a cost disadvantage. The introduction of Solvency II should significantly reduce the size of this effect.

2.15 Insurers based in other EU Member States that provide services via a branch or directly to UK customers are not subject to the FSA's prudential requirements. To this extent there would be an improvement in policyholder protection of UK customers resulting from the implementation of Solvency II. However, this is very much a secondary effect as the vast majority of insurance business written in the UK is provided

by insurers incorporated in the UK, either UK firms or subsidiaries of groups based in other countries.

2.16 The main benefits of Solvency II for UK companies relate mainly to its capacity to contribute to a deeper Single Market in insurance services in the EU and to improved competitiveness of the sector as a whole. There are also direct benefits for UK insurers and their customers, and in this report we examine the quantifiable benefits for the UK economy from implementing Solvency II.

2.17 On balance the Government believes that Solvency II should provide substantial net benefits for the UK. The aggregate costs of transition to the new Solvency II regime are likely to be significant and may lead to incremental ongoing costs when compared to the current FSA's prudential regime. However there are potentially significant benefits for UK consumers; Solvency II should lead to more competition throughout the EU and more efficient use of capital across the insurance sector. In turn this should lead to better value in insurance products, whether through innovations in product design or simply the provision of insurance cover at a lower price.

3

ESTIMATES OF COSTS OF IMPLEMENTING SOLVENCY II IN THE UK

3.1 This chapter sets out the costs that we expect will be incurred by insurers domiciled in the UK and by the FSA which will have responsibility for implementing Solvency II in the UK. This chapter addresses the following topics:

- The nature of costs arising from prudential regulation of insurance;
- Identifying the baseline: the FSA's prudential requirements for insurers;
- Comparing Solvency II with the FSA's prudential requirements for insurers;
- Estimates of costs resulting from the implementation in the UK of Solvency II; and
- Estimates of the FSA's costs of implementing Solvency II

Costs arising from prudential regulation

3.2 There are two kinds of costs that insurers incur as a result of prudential regulation: the cost of holding capital to meet regulatory capital requirements and the administrative costs of complying with the regulatory regime. These costs vary depending on the nature of the business being written and the complexity and scale of the insurance entity or insurance group. Implementation of Solvency II will involve changes to these costs for insurers.

3.3 With regard to the first kind of cost, should an insurer not have sufficient eligible capital to meet the new Solvency II requirements it will face both an initial one-off cost of raising the required shortfall of capital¹ and an ongoing cost of holding that additional capital (known as the cost of capital). The on-going cost of capital is an opportunity cost in that assets required to meet regulatory capital requirements cannot be deployed in other ways where they might attract a higher return, for example to support new business growth. For an individual firm, if the new Solvency II requirements are not higher than existing available capital, there might not be any incremental capital costs (initial or on-going) for that firm. However, the firm will continue to face costs of maintaining existing levels of capital where they are appropriate to Solvency II.

3.4 With regard to the second kind of cost – additional administrative costs for insurers of implementing Solvency II – these will have both a transitional element and an on-going element. For example, with regard to new reporting requirements there will be the initial one-off costs of setting up new reporting systems and the ongoing cost of making regular Solvency II reports.

3.5 Solvency II offers firms some options, in particular whether to calculate their Solvency Capital Requirement by an internal model or the standard formula. So to some extent the nature of the costs faced by firms will depend upon the options taken. In Chapter 2 it was noted that the Solvency II project uses the Lamfalussy arrangements to develop a prudential regime for EU insurers. While overall we can expect benefits from this approach, at this stage in the Solvency II project, before the Level 2 implementing measures have been drafted, it is especially difficult to make reliable estimates of the costs insurers will face.

¹ For example, if the firm chooses to raise additional equity capital to cover the shortfall, it would face the costs involved in a undertaking a share issue

Current FSA requirements

3.6 Before making any estimate of the costs of Solvency II we need to establish the baseline against which the additional costs are to be measured. There are three possible options:

- Solvency I, the current prudential requirements for insurers domiciled in the EU;
- The FSA's own prudential requirements for insurers domiciled in the UK – the ICAS regime; or
- A hypothetical state of the world in which there are no prudential regulatory requirements for insurers.

3.7 Of these three options we have chosen the second, as we assume that in the absence of Solvency II the FSA would continue to impose its current prudential requirements for insurers. Therefore the costs that UK insurers will incur because of Solvency II are those that are additional to the costs of complying with the ICAS regime. Of course, using this baseline for costs entails that the benefits which can be attributed to the implementation of Solvency II are those that are additional to the benefits which have already been generated by ICAS.

3.8 Having opted to use the FSA's current prudential regime as the baseline for measuring Solvency II's costs and benefits, we need to outline the various requirements that the FSA imposes. We can then compare these with the Solvency II framework directive to identify where Solvency II may lead to significant changes in the regulatory regime and associated costs. We split the FSA's current requirements into:

- **Quantitative elements** which will affect the amount of eligible assets and regulatory capital that insurers need to hold; and
- **Qualitative elements** which will affect the administrative costs insurers will incur in implementing Solvency II.

3.9 The main quantitative elements of the FSA's current prudential regime which will impact on UK insurer's current costs of holding regulatory capital are:

- The regulatory definition of insurance liabilities (technical provisions);
- Regulatory capital requirements; and
- The definition of assets and own funds which are eligible for regulatory purposes (i.e. available capital)

These are described more fully in Box 1 below.

Box I: current FSA Solvency Requirements

These are based on the current requirements set out in the FSA rulebook. The FSA regime is super-equivalent to the current EU directives in that it goes beyond the existing Solvency I requirements.

Valuation of insurance liabilities (technical provisions)

Under the FSA's prudential regime, life insurers operating a realistic balance sheet (see below) are required to assess their liabilities using market consistent methods. For life insurers not in this category, and for all non-life insurers, valuation of liabilities is not yet carried out on a market consistent basis, although these firms are beginning to make steps in this direction.

Regulatory capital requirements

Both life and non-life insurers are required to meet a Minimum Capital Requirement (MCR) which is broadly equivalent to Solvency I. The FSA also operates a risk-based capital requirement known as the Enhanced Capital Requirement (ECR). In addition, those life insurers with with-profit liabilities greater than £500 million must also prepare a "realistic balance sheet" which provides a market consistent assessment of the firm's assets and liabilities.

As well as these general requirements, all UK insurers under the FSA's regime must conduct a specific assessment of their own risk profile, known as the Individual Capital Assessment (ICA), in order to determine the level of capital required to mitigate the specific risks inherent in their business. The ICA is then compared to the capital requirements described above, and the FSA will review the firm's ICA and may decide to make an amendment in the form of Individual Capital Guidance (ICG). The ICA and ICG together comprise a 'soft' capital requirement on the firm². This forms the basis of the FSA's Individual Capital Adequacy Standards (ICAS) regime.

Groups requirements

For insurance groups, the Insurance Group Directive sets the group requirements at the level of the parent company operating in the EU. This is done by aggregating the requirements of the individual subsidiaries in the group.

Admissibility of assets and eligibility of available capital

Broadly speaking, assets are valued using a market consistent approach similar to the fair value concept used in IFRS³. Capital items are also categorized by quality using a tiering system. Firms must meet the minimum Solvency I quantitative restrictions on the admissibility of assets to meet capital requirements (in practice the Solvency I criteria does not tend to restrict UK firms).

3.10 The main qualitative elements of the FSA's current prudential regime which impact on a UK insurer's administrative costs are:

- The costs of calculating technical provisions and the regulatory capital requirements;
- The costs involved with undertaking the insurer's assessment of their own risk profile (the Individual Capital Assessment – ICA);

² The ICA is currently privately reported to the FSA and there is an implicit understanding that the firm will avoid dropping below its ICA requirement. This will change under SII as the SCR will become a hard requirement which the FSA is legally required to enforce

³ This is defined as the value at which the assets could be exchanged between knowledgeable, willing market participants in an arms-length transaction

- The requirements on internal controls, governance and risk management; and
- Firms' regulatory disclosures to the FSA

3.11 As described above in Box 1, UK insurers are required to conduct an ICA to assess the specific risks to their business and derive the level of regulatory capital needed to meet those risks. For many insurers this assessment may be based wholly or partly on the firm's own internal capital model. With regard to disclosure, UK insurers submit their ICA privately to the FSA on an annual basis. There are currently no public disclosure requirements in the ICAS regime, although information on the regulatory capital requirements (the MCR and the ECR) are disclosed in the insurer's regulatory returns.

Comparing Solvency II to ICAS

3.12 As described above, Solvency II is based on a 3-pillar approach. The quantitative and qualitative requirements contained in these 3 pillars are similar to those found under the FSA's prudential regime. The descriptions below are based on the present version of the Level 1 Directive text and the likely formation of Level 2 implementing measures.

3.13 The Pillar 1 requirements are as follows

- **Valuation of insurance liabilities (technical provisions):** Insurers will be able to value some of their liabilities directly using a market consistent approach, as is currently done by realistic reporting life insurers in the UK under ICAS. For other liabilities that cannot be valued directly using market data, a separate calculation using a best estimate plus risk margin approach will be used – this is more onerous than the current FSA requirements for some firms.
- **Regulatory capital requirements:** undertakings will be required to hold capital to meet a Minimum Capital Requirement (MCR) and a higher Solvency Capital Requirement (SCR). The SCR will be calibrated to a 99.5% confidence level over a one-year time horizon⁴ which is the same level of confidence used for the ICA. Firms can use either a European standard formula approach or their own internal model (subject to regulatory approval) to determine their SCR.
- **Eligibility of available capital:** Assets will be determined at fair value. As with the current FSA requirements there will be a tiering structure for eligible elements used to meet capital requirements. There will be no quantitative limits on asset admissibility.

3.14 For the larger UK firms preparing a realistic balance sheet under FSA rules, the basic Solvency II pillar 1 requirements described above are similar in structure to the current quantitative requirements as described in Box 1. For the smaller UK life insurers, and for all non-life insurers, the Pillar I provisions represent a more market consistent approach, particularly with regard to the valuations of assets and liabilities. UK insurers who wish to use their current ICA models to determine their SCR under Solvency II are likely to have to adapt and improve their models in order to gain regulatory approval under the new regime (this is explored in more detail in below).

⁴ The SCR is calibrated as the amount of capital that a firm would lose if it suffered a loss which has a 1 in 200 chance of occurring over a one year period. In other words, by holding this level of capital, there would be a 99.5% chance that the firm would be able to meet its obligations to policyholders over a one year period.

3.15 The main Pillar 2 requirements are as follows:

- **Own Risk and Capital Assessment (ORSA):** Firms will have to conduct an ORSA to assess their own risk profile, governance procedures and systems and controls. This assessment is similar to the current UK ICA; however the ORSA is much broader since it includes qualitative assessments of the insurer's governance, whereas the ICA has to date tended to focus mainly on the firm's quantitative capital requirements.
- **Supervisory review process:** EU insurers will be subject to risk-based prudential supervision. This will include an assessment of any internal model used by the undertaking. UK firms have experienced this since the start of the ICAS regime in 2004. Included in this is the power of supervisors to require firms to hold additional capital (a capital "add-on") if, for example, the supervisor considers that the SCR does not reflect the risk profile of the firm. Add-ons have been a feature of the UK regime in the form of Individual Capital Guidance given to firms.

3.16 Overall the Pillar 2 requirements will be familiar to UK firms. However, the level of assessment required is likely to be more robust under Solvency II. The Pillar 2 requirements are holistic and look across the whole of an insurer's business. Because these requirements are imposed through legislation they may well lead to some initial incremental costs for both firms and the FSA.

3.17 The Main Pillar 3 requirements are as follows:

- **Information for supervisors:** as is currently the case under the UK regime, insurers will be required to provide sufficient information directly to supervisors for them to conduct effective prudential supervision. The content of this information will be determined in level 2.
- **Public disclosure:** firms will have to publish a report on their Solvency and Financial Condition (SFC). This will be a new requirement for insurers across the EU, although UK firms will have disclosed some information as part of their regulatory returns.

3.18 Pillar 3 is also broadly similar in overall structure to the current ICAS approach, however UK firms will now face a much greater level of public disclosure due to the required publication of an annual SFC report. This is likely to include information which previously had been kept private, such as some data on the firm's internal model.

3.19 Therefore despite the similarity in overall design of the Solvency II framework to the ICAS regime, there are likely to be practical differences which may lead to increased costs for UK insurers. These are explored further in the next section. In reviewing these costs however, it should be borne in mind that UK insurers are in an advantageous position relative to their European counterparts. The baseline for most other EU firms will be the Solvency I rules, which bear little resemblance to the Solvency II (or ICAS) framework, and as such are likely to impose much greater costs on other EU firms.

Basis of our calculations

3.20 We have described above the baseline for our analysis and the differences between this and the Solvency II framework which we consider are likely to lead to additional costs. Below we provide an estimate of these incremental costs involved in implementing the directive in the UK. As described above these are divided into capital and administrative costs.

3.21 Estimates of the likely incremental capital costs that insurers may face are based on quantitative data underlying the UK report for the third Quantitative Impact Study (QIS 3). This was conducted by CEIOPS during 2007 to test the provisional methodology and calibration of the Solvency II requirements. With regard to capital costs, we consider that QIS 3 data provides us with a useful early indication of the costs that insurers are likely to face. In general the use of QIS 3 data and any analysis based on it must be accompanied with the following caveats: the technical specification of the QIS 3 exercise is provisional only and does not represent the final specification of Level 2. Moreover, the QIS 3 data were provided by firms on a ‘best effort’ basis⁵.

3.22 It has also been necessary to extrapolate the results from the QIS 3 sample, which means that there is added uncertainty in some of the numbers, particularly for small and medium sized firms. This, together with the fact that the level 1 text has not yet been agreed, means that the numbers provided in this analysis should be considered only as a provisional estimate of the likely costs of Solvency II implementation. They are subject to considerable uncertainty.

3.23 In terms of administrative costs, the information is derived from the qualitative responses to QIS3 provided by firms on the likely cost of implementation, based on their current understanding of what may be contained in Solvency II. As such, it is likely to be subjective to some degree, and in particular may not include all the costs of developing an internal model that would achieve full regulatory approval under the new regime. Furthermore, participation in the QIS 3 exercise was voluntary and as a result the sample of firms providing information may well not be a fair representation of the UK insurance sector as a whole.

Incremental capital costs

3.24 The additional capital costs are a function of the capital that UK firms will have to hold under Solvency II. The first step in this analysis is to determine the level of the potential increase in capital requirements under Solvency II if firms were to use the standardised approach to calculating the SCR, as specified in QIS 3. This is detailed in Table 2 below.

⁵ For instance, figures may not be to an auditable standard, and where precise figures were not available approximations may have been used.

Table 2: capital requirements for the UK insurance industry

Type of firm	Internal model ¹	Solvency II standard formula ²	Difference	
	£ billion		£ billion	% ³
Life firms	61.3	69.5	8.2	13
Small	0.6	0.7	0.1	17
Medium	10.7	11.5	0.8	7
Large	50.0	57.3	7.3	15
Non-life firms	24.8	41.1	16.3	66
Small	3.1	5.2	2.1	68
Medium	4.4	7.5	3.1	70
Large	17.3	28.4	11.1	64
Total	86.3	110.6	24.3	28

Source: QIS3 data and FSA calculations. Data has been extrapolated and grossed-up to industry levels.

¹ Derived from data for firms with internal model calculations conducted for QIS 3

² Estimates of Solvency II capital requirements calculated using the standard formula calibration in QIS 3

³ Percent of internal model requirement

3.25 This table shows the difference between the capital requirements generated by the firms' internal models and those determined by the standard formula SCR, both of which were derived from data submitted in QIS 3. The internal models used to produce this QIS 3 data were largely based on the models used by firms for their ICAs under the FSA's regime⁶. We therefore consider that Table 2 demonstrates the potential effect of switching from the FSA's ICAS requirements to the Solvency II SCR as determined by the standard formula in QIS 3.

3.26 Firms will have the option to calculate the Solvency II SCR using an internal model, and the incentive to adopt such a model is that the resulting SCR is likely to be lower than an SCR generated by the standard formula. Therefore it is reasonable to see the 'difference' column in Table 2 as representing the upper bound of changes to capital requirements resulting from Solvency II.

3.27 Following this, the results show that overall capital requirements are expected to increase for the life sector by a total of **£8.2 billion** (a 13% rise). We explain this increase as follows. Firstly, we would expect that capital requirements generated using a standard formula would be higher for the industry overall than capital requirements calculated using internal models. Part of the incentive for firms to develop models is to determine capital requirements which better reflect their own individual risk profiles,

⁶ Given that the numbers submitted do not correspond exactly to the data those firms provided in their actual ICA submissions to the FSA, there may be differences between these figures and other published aggregate ICAS data. This may be due to factors such as varying accounting dates and possible differences in methodology used in firms' calculations, as well as the fact that only a relatively small sample of firms provided QIS 3 internal model data.

while still maintaining the required level of policyholder protection. A standard formula by comparison is a much cruder measure of the risks in any particular firm which is likely to lead to higher capital requirements, reflecting the less accurate fit between the firm's risk profile and its capital requirements.

3.28 A second explanation for the increase in life insurers' capital requirements relates to the calibration of the SCR standard formula. As mentioned in the start of this section, the QIS 3 specification of the SCR will be subject to further refinement. Several UK life insurers who took part in the exercise commented that some parts of the standard formula were over-calibrated. For example, the capital charge for the effect of a catastrophe event on the number of policyholders who decide to surrender their policies was considered to be too high⁷. Similarly, there were differences between the standard formula and internal models in the methods used to determine the amount of capital required to mitigate operational risk, and with regard to the levels of diversification assumed. These and other possible divergences go some way towards explaining the increase in capital requirements for the life sector shown in the above table.

3.29 For the non-life sector, overall capital requirements are expected to rise by **£16.3 billion** (a 66% increase). This appears to be a substantial increase which is materially different from the effect on the life sector. There are several possible reasons for this. Firstly, we consider that there are substantial problems with the calibration of the SCR standard formula for non-life business. UK firms taking part in QIS 3 commented that the non-life underwriting risk module⁸ of this formula had been mis-calibrated, leading to excessively high capital charges. CEIOPS has acknowledged that further work is needed to refine this module. Given that the non-life underwriting risk module is a major part of the SCR for non-life business, and that similar problems were not reported to the same degree for the life underwriting risk module, this goes some way towards explaining the greater increase in capital requirements for the non-life sector.

3.30 A second reason for the large increase in non-life insurers' capital requirements relates to the comparison between internal models and the standard formula. As with life firms, non-life insurers can use internal models to generate a capital requirement which is a better reflection of their risk profile than one determined by a standard approach. An example of this is that firms using internal models to determine capital requirements typically allow for geographical diversification⁹. Another example is that non-life insurers using models typically include an allowance for the expected profitability of future business¹⁰. The QIS 3 specification of the SCR standard formula did not allow for geographical diversification of risks or the expected profit from new business, and so the Solvency II capital requirements in Table 2 are higher as a result.

3.31 Overall we consider that these elements are sufficient to explain the increases in capital requirements under Solvency II as shown in table 2. However, we note that UK firms will wish to continue to use internal models to determine their capital

⁷ This test requires life insurers operating unit-linked policies to hold an amount of capital based on the assumption that in a catastrophe event, 75% of policyholders would immediately surrender (voluntarily cash in) their policies. This assumption of 75% surrender rate is considered to be too high, leading to an overly-prudent capital charge for this risk.

⁸ This module requires insurers to hold an amount of capital to cover the specific insurance risks relating to the uncertainty of underwriting non-life business (such as the risk that the insurer does not receive adequate premiums to cover its liabilities).

⁹ For an insurer whose risks are spread across the globe (i.e. well diversified) there will be less chance that all these risks will crystallize at the same time, compared to an insurer whose risks are all in the same place.

¹⁰ This assumption leads to a credit in the insurer's capital requirement to reflect the expected profitability of new business that the insurer expects to write during the time horizon for which the capital requirement is calibrated (one year in the case of the Solvency Capital Requirement which Solvency II will impose).

requirements under Solvency II as they have been doing under the FSA regime. Therefore we consider that many firms will not be using the standard formula to determine their SCR and so are likely to face capital requirements closer to the results in the internal models column in the table¹¹.

Available capital in the UK industry

3.32 The change in capital requirements is only part of the impact on UK firms. Many insurers choose to hold capital in excess of their regulatory requirements. This capital “buffer” varies considerably between firms and depends on factors such as the undertaking’s risk appetite, the volatility of capital prices in the market, and the external credit rating sought by the undertaking. Moreover, many firms may decide to hold an increased buffer in the early years of Solvency II to reflect their initial uncertainty as to how the new regime will operate in practice. Other insurers may decide to maintain over time a constant buffer above their SCR. The total amount of available capital held by the insurer under Solvency II will therefore depend on both the level of the SCR and the amount of excess capital – the buffer – which the firm desires to hold above the SCR.

3.33 Due to the significance of the concept of a capital buffer, and the strong likelihood that firms will continue to hold capital in excess of their SCR under Solvency II, we have provided the following analysis. This considers two scenarios:

- **Scenario A** assumes UK insurers choose to hold the same capital buffer (in percentage terms) under Solvency II as they hold in effect under the present FSA regime; and
- **Scenario B** examines whether the increase in capital requirements shown in Table 2 can be fully absorbed by the current buffers held by firms – in other words, whether UK insurers as a whole would have to raise any new capital under Solvency II if they were happy for their current buffers to be used up instead (i.e. no incremental capital costs).

Table 3 below summarises the amount incremental capital costs that would be faced by firms under these two scenarios, based on our estimate of the current level of eligible capital and excess capital buffer held in the UK insurance industry¹², along with the estimates of the Solvency II standard formula SCR from Table 2 above. For a full breakdown of these calculations see the table in annex A.

¹¹ The internal model requirements under Solvency II are likely to be more robust than the FSA’s ICAS requirements and so we anticipate that there would be some increase in capital requirements even for internally modeled SCRs. The main reason is that under Solvency II models will have to be approved by the supervisor.

¹² For the purpose of this analysis, the current levels of eligible capital and capital requirements (derived from internal models) are based on an extrapolation to all firms of the QIS3 results from participating firms, which incorporate the proposed new methodology for assessing the provisions for insurance liabilities. The total figures may therefore not all reconcile with current aggregate data published elsewhere.

Table 3: summary of incremental capital costs of Solvency II

Incremental capital costs	Life	Non-life	Total
	£ billion		
SII capital requirements	69.5	41.1	110.6
Eligible capital	91.9	64.3	156.2
Basic surplus	22.4	23.2	45.6
Scenario A			
Additional capital required	13.8	36.1	50.0
Cost of capital	3.5%	3.5%	3.5%
Incremental cost	0.5	1.3	1.8
Scenario B			
Additional capital required	0.0	0.0	0.0
Cost of capital	3.5%	3.5%	3.5%
Incremental cost	0.0	0.0	0.0

Source: summarised from data in the table in annex A

3.34 Under Scenario A, we estimated that Solvency will require firms to raise additional capital of £13.8 billion for the life sector and £36.1 billion for the non-life sector. However, for the reasons given above, these are likely to be over-estimates of the extra capital that would actually be required in this scenario, and in the case of the non-life sector the over-estimate is very significant. Under Scenario A where firms raise the required shortfall of capital, these firms will face an ongoing cost of holding that additional capital (the cost of capital). We have assumed a weighted average cost of capital for firms of 3.5%¹³. So under scenario A life-sector firms would face ongoing costs of **£0.5 billion** p.a. and non-life firms would face **£1.3 billion** p.a. to hold the additional amounts of capital they would need to raise. Again it is important to note that these costs would only occur if firms used the QIS 3 specified standardised approach to determine the SCR.

3.35 Scenario B shows that, based on our estimate of the current amount of eligible capital in the UK industry, for all categories of firms the increase in capital requirements could be fully absorbed by the existing capital buffer. This means that the UK insurance industry as a whole is currently well capitalised to the extent that no additional capital needs to be raised in order to meet Solvency II capital requirements. In reality the impact may vary considerably between firms. Some UK insurers may have sufficient excess capital already and may be prepared to use that excess to absorb any increase to their capital requirements. Other firms will wish to maintain their current level of excess capital and will therefore choose to raise additional funds.

¹³ Source: FSA, Annex 3 of CPI90 and of CPI95

Incremental administrative (non-capital) costs

3.36 As described above, firms will face additional administrative costs from complying with the new Solvency II regime. These can broadly be attributed to the following qualitative elements:

- **The costs of calculating technical provisions and regulatory capital requirements:** includes the costs of technical specialists (such as professional actuaries) and systems necessary to carry out valuation using the new Solvency II specification. Ultimately the Board and senior management will be responsible for ensuring that the firm complies with the Directive requirements; so there will be additional resource costs incurred at senior level, in particular as insurers assimilate the detail of Solvency II's requirements.
- **Insurers' assessment of their own risk profile, internal controls, governance and risk management (the ORSA):** these costs will to some extent have been assumed by firms who will have conducted an ICA under the current UK regime. Firms who already use an integrated risk and capital internal model which would be approved under Solvency II will have further sunk costs. Other firms who may decide to develop an internal model will face substantially greater cost burdens to construct the model (but such firms would be likely to gain from lower capital requirements as a result of using the model).
- **Regulatory disclosures to the FSA and public disclosures:** new systems and procedures will need to be put in place to deal with the new reporting requirements for both supervisory reporting and public disclosure under Solvency II.

3.37 Based on these categories we have conducted an analysis of the survey data from the QIS 3 UK report. The data in the following table is an estimation by the firms of the additional administrative costs they expect to face under Solvency II. We considered separately the life and non-life insurance sectors, and within each sector considered costs for small, medium and large firms. Also detailed are the additional costs faced by groups above those incurred by the subsidiaries that make up the group.

3.38 We believe that the estimates made by firms of the incremental administrative costs that they will face is subject to a large degree of uncertainty, and it is possible that the data in the following table may be an underestimate of the total eventual administrative costs¹⁴.

¹⁴ It should be noted that QIS 3 asked firms to estimate resource/costs of doing QIS3 calculations, i.e. technical provisions, MCR and SCR standard formula. Only a few firms provided an estimate of model development resources. Moreover, these estimates should not be interpreted as the whole cost of implementation, as they refer only to Pillar 1 requirements.

Table 4: estimates of incremental administrative costs of Solvency II

Type of firm	Number of firms	Total person months	£ million ¹	Total person months p.a.	£ million ¹ p.a.
		One-off costs		Ongoing costs	
Life firms	173	6,320	50.9	510	4.2
Small	74	230	1.8	75	0.6
Medium	61	290	2.4	55	0.5
Large	38	5,800	46.7	380	3.1
Non-life firms	225	1,380	11.0	420	3.4
Small	140	120	0.9	50	0.4
Medium	60	360	2.9	70	0.6
Large	25	900	7.2	300	2.4
All solo firms	398	7,700	61.9	930	7.6
Groups²	44	340	2.8	100	0.8
Small	14	80	0.7	20	0.2
Medium	15	120	1.0	30	0.2
Large	15	140	1.1	50	0.4
Total UK	442	8,040	64.7	1,030	8.4

Source: FSA calculations based on QIS 3 survey responses

¹ Assumes cost of £8,000 per person month

² Costs incurred by groups in addition to those incurred by solo firms that make up the group

3.39 The table shows that solo entities are expected to face additional one-off costs of approximately **£62 million** and additional ongoing costs of **£7.6 million**. However, if the overall costs were calculated by reference to the highest cost estimates made by individual firms during QIS 3, then the one-off costs could be as high as £122 million, and ongoing costs could rise by £21 million each year¹⁵.

3.40 The vast majority of costs appear to be borne by large life insurers, with average one-off costs in the above table of approximately £1.2 million per life insurer. The average one-off cost in the above table of approximately £300,000 per UK non-life large insurer appears low by comparison to the life estimate. However, this may be partly explained by the presence of two outliers in the life data submissions who may well have included estimates of likely modelling costs on fairly conservative assumptions, that were not made by other firms. If these two outliers were excluded, the estimate for the one-off costs (excluding modelling costs) for large life insurers would be very close to the average costs for the large non-life insurers.

3.41 The majority of administrative costs for larger firms are likely to be incurred in the design and operation of internal models. We expect that these firms that are currently using internal models to determine their capital requirements under ICAS will

¹⁵ Based on FSA calculations from QIS 3 data.

wish to continue to use these models under Solvency II to calculate their SCR. Although currently having an internal model up and running will imply a level of sunk costs for UK firms, insurers in this position will still have to adapt their models for use under the Solvency II regime.

3.42 It is difficult to assess at this stage the incremental modelling costs relevant to Solvency II. However, it is likely that firms will have to make some improvements to their ICA models in order to use them under the new regime. Possible reasons for this include:

- **Better integration of risk and capital management:** ICAS does not require UK firms to submit economic models, but under Solvency II internal models will have to be developed for the firm's own risk and capital management in order to determine their true economic capital requirement. This greater integration of economic and regulatory models¹⁶ is likely to impose costs on firms.
- **Increased scope of the model:** insurers will need to demonstrate that the model is fully integrated into the governance procedures and business strategy of the firm. As such the model under Solvency II will have to be a broader and more in depth analysis than is required for an ICA.
- **Greater ownership by the firm's Board:** senior management will be required to demonstrate that they have sufficient understanding of their model to properly demonstrate its use within the business.

3.43 The extent to which insurers using models will have to adapt them will obviously vary from firm to firm. Some UK insurers may have developed their ICA models into an integrated risk and capital model which they use to drive their business; i.e. much closer to the Solvency II requirements. Furthermore, the FSA has already begun to move UK insurers towards the expected Solvency II modelling standard¹⁷. Therefore UK firms will be at a considerable advantage to other European insurers, many of whom have little or no experience of using internal models to determine capital requirements.

3.44 From the data firms submitted as shown in Table 4 we consider it possible that UK insurers have underestimated the incremental costs relating to administration, information provision, model adaptation and other qualitative elements of Solvency II. This may be natural at this stage of the development of Solvency II given the uncertainty that exists as to the precise requirements for models that will be determined at level 2. Furthermore, the incremental modelling costs of Solvency II should reflect the costs of securing supervisory approval of the model, but not the model development costs that a firm would in any case choose to incur for business purposes. Some firms in the sample may have reflected this in their QIS 3 submissions.

3.45 We note that for smaller firms, administrative costs are anticipated to be less for both life and non-life firms, since these undertakings are less likely to be using internal models.

¹⁶ This is consistent with developments at the IAIS as defined in its Guidance paper No. 2.2.7 on the use of internal models for risk and capital management by insurers (October 2007).

¹⁷ The FSA has published Policy Statement 06/14: Prudential changes for insurers (December 2006) which introduced sub-principles and guidance for insurers conducting an ICA.

The FSA's costs of implementing Solvency II

3.46 As the regulator responsible for prudential supervision of UK insurers and reinsurers, the FSA will face costs of implementing the Solvency II regime. This will be in the form of personnel and systems necessary to perform the supervisory review function specified in the directive.

3.47 The UK has already implemented prudential policy for insurers with broadly similar principles as Solvency II in the form of the ICAS regime. Therefore some of the regulatory costs of implementing Solvency II may have already been incurred. Of the additional direct costs likely to be incurred by the FSA, one-off costs of implementation are estimated to be in the range of between £4m and £12.5 million, with ongoing costs between **£500,000** and **£2 million** per annum. The lower bands are based on the direct costs for the ICAS regime, while the upper bands relate to the costs for implementing the Capital Requirements Directive on banking supervision.

3.48 Direct costs for HM Treasury and other UK government institutions are not expected to be material.

4

ESTIMATE OF BENEFITS ARISING FROM IMPLEMENTING SOLVENCY II IN THE UK

4.1 In its impact assessment the European Commission anticipated considerable benefits across the EU as a result of Solvency II. These can be categorized as:

- **Policyholder benefits:** solvency II will ensure a uniform and enhanced level of policyholder protection across the EU as a result of strengthened risk-based capital requirements, effective risk management by insurers, and robust supervision by authorities.
- **Industry benefits:** the Solvency II regime will promote more integrated risk and capital management and align supervisory requirements with market practices. The further integration and international competitiveness of the EU insurance industry will both be enhanced, and a more level-playing field will be created across Member States.
- **Economic benefits:** better and more efficient allocation of capital to meet insurance risks across the EU, leading to a lower overall cost of capital. Strengthens the role of insurers as institutional investors contributing towards European economic growth.
- **Supervisory benefits:** supervisors will gain risk-based tools enabling more effective supervision of insurance undertakings. Streamlining responsibilities and communication in the supervision of groups will allow for greater understanding of supervised entities across the EU.

4.2 UK insurers and reinsurers will gain these benefits along with all undertakings across the EU. However some of these benefits will have already been assumed by the UK industry since 2004 due to the implementation of the ICAS regime, which as noted above contains the same risk-based prudential structure as Solvency II. We have identified what we consider to be the key benefits to the UK above those already being enjoyed under ICAS.

Box 2: a new approach to group supervision

The Commission's Solvency II proposal includes an overhaul of the requirements of insurance and reinsurance groups which aims to streamline the supervision of these entities across the EU. The proposal includes the following key features:

1. Diversification benefits at group level – the proposal allows groups to take advantage of diversification on a group-wide basis. This allowance reflects the true economic benefits inherent in the group structure.
2. Appointment of a group supervisor – a single supervisory authority will be appointed with primary responsibility for key elements of supervision (such as the ability to approve the group-wide capital requirement). This will streamline supervisory decision-making.
3. Group-wide capital requirement – the proposal allows the use of a group-wide internal model to determine the capital requirements for the group as a whole. This is in-line with the arrangements under the Capital Requirements Directive for the banking sector.
4. Group support – groups can apply to use the financial resources of the group as a guarantee to partially meet capital requirements of particular subsidiaries. This is an innovative proposal which seeks to facilitate the transfer of resources to where they are needed in the group, thereby improving capital management.
5. Improved communication between supervisors – the proposal requires robust coordination and communication arrangements to be put in place between the group supervisor and the local supervisors of the group's subsidiaries. This will reduce administrative burdens on groups having to report to multiple authorities.

The new approach in Solvency II represents a significant step forward in the supervision of insurance groups in the EU and is strongly supported by the UK. The features described above would translate into considerable benefits for EU groups.

Benefits for UK insurers

4.3 The list below is a summary of the tangible benefits of Solvency II for UK insurers which should feed through to better value insurance products for UK consumers:

- Removal of the 'twin peaks' regime which requires UK insurers to meet both the current EU solvency requirements (Solvency I) and the FSA's ICAS requirements, leading instead to a single streamlined set of prudential rules;
- A more streamlined approach to supervision of insurance groups (see Box 2);
- Some greater flexibility in the assets insurers are permitted to hold to match technical provisions and capital requirements;
- Some greater flexibility in the capital structure insurers are permitted to maintain to comply with regulatory capital requirements;
- A harmonized EU solvency regime, reducing the costs of operation in different Member States (either through a branch or a subsidiary). Alongside the new approach to groups supervision this will encourage greater cross-European expansion by insurance undertakings;

- Consistency in the approach to prudential capital requirements between the banking and insurance sector, potentially reducing frictional capital costs;
- Greater transparency possibly leading to lower costs of raising external capital. This effect may be increased by the improved consistency with International Financial Reporting Standards;
- Some administrative cost savings due to the consolidation of the existing insurance prudential directives into a single legal document; and
- Potential for greater flexibility in tailoring the insurer's risk profile through, for example, regulatory recognition of non-financial derivatives and a larger market in insurance securities and lower costs of securitisation.

4.4 The economic benefits of Solvency II will help to bring about greater integration of insurance and reinsurance business and thereby further the European Single Market in Financial Services. This is consistent with the objectives of the EU Financial Services Action Plan which includes legislation such as the Markets in Financial Instruments Directive (MiFID) and the Capital Requirements Directive for banking. When compared to these sectors, there is currently little cross-boarder activity in the provision of insurance services across the EU. This is likely to change as a result of Solvency II and we consider this to be a key benefit of the new regime.

Quantitative assessment of UK benefits

4.5 In this section we have assessed the quantifiable benefits of implementing Solvency II in the UK. In its Impact Assessment the Commission described the benefits of Solvency II as follows:

“The additional administrative costs... will be offset by direct benefits arising, for example, from a lower cost-of-capital for insurance undertakings, as transparency and confidence in the insurance sector will increase. Using current overall capital requirements of around €300 billion a year....as a rough guide, then even a small drop (0.05% to 0.1% say) in the cost of capital could be expected to produce savings of the order of €100 to €200 million a year for the EU insurance industry.

However, the main benefit that will offset the administrative costs associated with the introduction of Solvency II will be the ability of insurers to actively manage their risk and capital requirements and thus optimise their risk/return profile, for example through the use of innovative risk mitigation techniques and by diversifying their activities and investments.

Given the overall size of EU insurers' balance sheets, even a small improvement in the efficiency of the industry with respect to the management of risk should deliver tangible benefits. Using improvements in investment returns as a rough proxy for efficiency gains would suggest that even a very small improvement in the efficient management of risk could be expected to result in improved returns of several billion Euros a year, as EU25 insurers investments amount to almost €6,000 billion.”

¹ Costs that arise in the insurance sector due to a regulatory structure designed to protect policyholders at the possible expense of investors.

4.6 If we calculate the benefit estimates suggested in the Commission's Impact Assessment at the UK level we find the following results. On the basis of the capital requirement data provided elsewhere in this document of £86.3 to £110.6 billion for the UK direct insurance sector, a reduction in capital costs of 5-10 basis points implies an annual benefit in the range of £43 to £111 million for the UK industry, relating to a lower cost of capital as transparency and confidence in the insurance sector increase. This benefit might not be evenly distributed across the industry and in principle it seems likely that listed companies might be likely to benefit more from increased transparency in the insurance sector. On the basis that the FSA's ICAS regime has already led to improvements in transparency in the UK, the equivalent benefits will lie somewhere in the range of 100 per cent and zero per cent of those stated by the Commission. We assume that only half of the benefits estimated by the Commission for the EU as a whole are realizable in the UK, and this generates a mid-point estimate of **£38.5 million** per year.

4.7 The Commission's Impact Assessment suggests that the benefits realized from more efficient risk management and asset allocation could amount to around five basis points of the total asset value, on an annual basis. Compared with the aggregate asset value figure for the EU of €6,000 billion, the equivalent UK figure is approximately €1,600 billion, or £1,151 billion². As with the potential benefits from reduced cost of capital, we consider that the impact of the ICAS regime is to limit the potential for benefits flowing from improved risk management. On this basis we have assumed, as above, that only half of the benefits that could be available at the EU level as implied in the Commission's Impact Assessment are available in the UK. This leads to an implied annual benefit of **£287.8 million** for the UK insurance sector.

4.8 This source of benefit is particularly important for the overall analysis. Although we have assumed a significantly smaller benefit for the UK insurance sector than that assumed by the Commission for the EU as a whole (with good reason), there are also factors which suggest the adjustment we have made leads to a cautious estimate of potential benefits. Firstly although the ICAS regime has contributed to a UK industry-wide improvement in risk management and concomitant benefits in the efficient use of capital and allocation of assets, many firms in other Member States will have achieved similar improvements and this is all the more likely for the larger firms and insurance groups. Since just the largest 20 groups operating in the EU hold approximately 60% of all assets held by EU insurers³ the differences between feasible benefits from Solvency II at the EU level and at the UK level may not be so great.

4.9 Secondly, Solvency II includes a proposal on the supervisory framework for insurance groups which we believe should have a major impact on the Single Market and would enable all insurance groups in the EU to operate more efficiently. To the extent that the benefits of Solvency II in the form of more efficient asset allocation are delivered through the groups supervision model that has been proposed, UK groups will benefit from this just as much as groups with head offices in other Member States.

4.10 Finally, given that Solvency II is a Single Market directive, it will enable UK companies to operate more efficiently across the EU. Where they provide services in another Member State either directly or via a branch symmetrical benefits should be available to UK insurers as to those located in other Member States. It is extremely

² Source: CEA Topography of EU25 insurance market. Converted using an exchange rate of 1 GBP = 1.39 Euros (2005 rate used to match the data in the CEA report).

³ Source: CEA European insurance in figures, June 2006

difficult to provide any reliable estimate of the behavioural consequences of a change in regulatory regime as fundamental as Solvency II is for the insurance sector but it is plausible that the significant increase in consistency between Member States in their approach to prudential supervision could lead to a material change in the quantity of cross border insurance service provision. In addition, to the extent that companies in other Member States provide insurance services into the UK directly or via branches they currently benefit from a competitive advantage as they are not required to comply with the FSA's ICAS regime. This advantage will disappear under Solvency II.

4.11 The final source of quantifiable benefits from Solvency II is the removal of the need for a 'twin peaks' approach for UK insurers whereby they are obliged to meet both the Solvency I requirements and those imposed by the FSA. Among other elements this requires life insurers with insurance liabilities of £500 million or more to calculate two sets of technical provisions, one on a 'regulatory' basis to comply with Solvency I and a second on a 'realistic' basis, to comply with the FSA's market consistent approach to with-profits business. It is difficult to quantify the benefits of removing the twin peaks regime so we have considered the FSA's own estimates of the administrative costs of this regime and assumed that its removal could lead to a cost saving that is in the range of 0-50% of the estimated costs. On that basis, and assuming that the actual savings are at the mid-point of this range we estimate a saving of **£3.4 million** annually for the UK insurance sector. This saving needs to be compared with the additional administrative cost relating to implementing Solvency II of £14.3 million annually.

4.12 In total the annual benefits due to the implementation of Solvency II are estimated at **£329.7 million**. This can be compared with the figures for incremental capital costs and administrative costs estimated in Chapter 3 to determine the net quantifiable benefit of implementing Solvency II in the UK⁴:

Table 5: net quantifiable benefits of Solvency II

	£m
Ongoing benefits	
Increased capital transparency	287.8
Improvements in insurers' risk profiles	38.5
Cost savings from ICAS	3.4
Total benefits	329.7
Ongoing costs	
Incremental capital costs	(218.8)
Incremental administrative costs	(14.3)
Direct costs to FSA	(1.3)
Total costs	(233.1)
NET BENEFITS	96.6

Source: HM Treasury calculations based on data in this report

⁴ Using a weighted average cost of capital of 3.5%. See annex A for further details of our ongoing costs assumptions.

4.13 The effect on the UK economy of implementing Solvency II therefore amounts to approximately **£97 million of net quantifiable benefits on an ongoing basis**. Other less quantifiable effects are considered below.

Qualitative benefits

Benefits for UK policyholders

4.14 Policyholders in the UK have benefited since 2004 from the level of protection required under the FSA's ICAS regime. As a result of these requirements, UK insurers have been required to hold capital to a 99.5% level of confidence over a one year time frame. Solvency II adopts this same level of confidence. Many of the benefits of enhanced policyholder protection will therefore already have been assumed in the UK. The following represent additional benefits that can be expected for UK policyholders under Solvency II:

- Stronger competition resulting from a deeper single market in insurance services, leading to better value products and more product innovation;
- Potentially more efficient use of capital resulting in better value products; and
- A more robust insurance sector, leading to a lower risk of instability in insurance markets across the whole of the EU.

4.15 Given that UK policyholders may be exposed to enhanced competition for their premiums from insurers in other Member States as a result of Solvency II, the new capital requirements leading to enhanced protection for all EU policyholders will obviously be of considerable importance to UK policyholders buying policies abroad or from a foreign-owned branch in the UK. These customers would not otherwise be able to take advantage of the level of protection available under the ICAS regime.

Possible additional effects on the UK industry

4.16 The introduction of Solvency II may have an additional impact on the UK insurance industry beyond the direct costs and benefits considered above. This represents possible unintended consequences of the new regime. Many of these may be short-term side-effects which will not have an ongoing impact on the UK industry:

- **Impact on insurability:** as Solvency II will align the regulatory treatment of risks with their true economic cost, riskier insurance products will receive higher capital requirements. This may lead to a reduction in coverage for some types of insurance. However, since the FSA currently operates a risk-based capital regime we consider that this effect will be substantially less in the UK when compared to other Member States. Furthermore, in the long-term insurers will provide such products if they are economically viable, for example by improving their risk mitigation techniques to offset the capital costs of riskier business.
- **Impact on asset allocation:** the SCR will attach higher capital charges to riskier assets, such as equities, compared to less risky investments like fixed-income securities. This may lead to insurers purchasing more bonds at the expense of equity, with the corresponding effect on the EU equity markets. Such portfolio rebalancing will vary considerably between insurers, and some undertakings may decide that the additional returns on equity (relative to fixed-income) offset the increased capital charge. This effect will be less for those UK insurers using a realistic balance sheet since their

current equity stress test is closer to that which is likely to be used under Solvency II.

- **Impact on pricing:** higher capital costs may to some extent be passed on to policyholders in the form of higher premiums. This would have less impact in the UK due to the current FSA regime. We consider that such increases if they occur are likely to be short-term in nature, and that in the long run prices will return to normal patterns of demand and supply.
- **Increased consolidation across the EU:** the recognition of diversification benefits inherent in the insurance business model will mean that larger, well diversified firms are likely to benefit from reduced capital requirements compared to solo entities who are less well diversified. Insurance groups in particular will benefit from diversification effects across the group entity under the current proposal. As a measure designed to deepen the Single Market, Solvency II is likely to foster trends towards consolidation in the EU insurance sector which exist in any case. A level competitive playing field throughout the EU will tend to increase competition in each Member State. The resulting drive to offer better value products is a key benefit of Solvency II for EU customers, but for the sector it is likely to bring some acceleration in the pace of structural adjustment.

A

INCREMENTAL CAPITAL

A.1 This table shows the calculations supporting the analysis used in chapter 3 with regard to the amount of incremental capital that would be raised under scenarios A and B.

Category	Key	Life Sector (by size)				Non-life Sector (by size)				Grand Total
		S	M	L	Total	S	M	L	Total	
<i>£ billion¹</i>										
ICAS estimates										
Capital requirement ²	A	0.6	10.7	50.0	61.3	3.1	4.4	17.3	24.8	86.1
Eligible Capital	B	1.2	15.4	85.4	102.0	7.0	10.0	37.9	54.9	156.9
Buffer (absolute amount) ³	C = (B - A)	0.6	4.7	35.4	40.7	3.9	5.6	20.6	30.1	70.8
Buffer as % of current CR	D	98%	44%	71%	66%	124%	118%	119%	121%	82%
Solvency II estimates										
Capital Requirements	E	0.7	11.5	57.3	69.5	5.2	7.5	28.4	41.1	110.6
Eligible Capital	F	1.1	13.9	76.9	91.9	8.2	11.7	44.4	64.3	156.2
Scenario A⁴										
Buffer	G = (E x D)	0.7	5.0	40.6	46.3	6.5	9.6	33.8	49.9	96.2
Desired Capital ⁵	H = (E + G)	1.4	16.5	97.9	115.8	11.7	17.1	62.2	91.0	206.8
Incremental capital ⁶	I = (H - B)	0.2	1.1	12.5	13.8	4.7	7.1	24.3	36.1	50.0
Scenario B⁷										
Buffer	J = (B - E)	0.5	3.9	28.1	32.5	1.8	2.5	9.5	13.8	46.3
Desired Capital	K = B	1.2	15.4	85.4	102.0	7.0	10.0	37.9	54.9	156.9
Incremental capital ⁶	L = (K - B)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0

Source: FSA calculations based on extrapolations from QIS3 data

¹ Data converted from € million at exchange rate of EUR/GBP = 1.48 (rate used as at 31/12/06 - year-end date for QIS 3 data provided by UK firms)

² Taken from the "internal models" column in table 2

³ Calculated as current eligible capital minus current capital requirements

⁴ Buffer remains constant as a percentage of capital requirements

⁵ Desired capital is equal to the Solvency II capital required plus the buffer assumed

⁶ Calculated as the capital firms would need to hold under Solvency II (equal to their SCR) plus a buffer, less the eligible capital currently held

⁷ Increase in capital requirement absorbed by current buffer

A.2 The total capital increase of £50 billion under Scenario A is not a realistic upper bound to the increased regulatory capital UK insurers would need to hold under Solvency II. Firstly, the QIS 3 version of the standard formula is only a test and more material divergences from an appropriate calibration should be addressed before any level 2 implementing measures are finally agreed. Secondly, many firms, especially larger ones (which hold the bulk of total industry-wide capital), can be expected to adopt an internal model to calculate their SCR, and if the standard formula were inappropriately calibrated the incentive to adopt an internal model would be increased.

A.3 For the purposes of calculating regulatory capital costs we have therefore assumed that the incremental capital required by insurers is only 25% of the amounts shown in Scenario A. The estimated increase in regulatory capital used in our ongoing costs analysis in Chapter 4 is then the mid-point between this adjusted value and Scenario B where all additional regulatory capital requirements are assumed to be absorbed in the buffer of available capital. We consider that this is a fair assumption given that, as shown in Scenario B, the UK industry is sufficiently well capitalised so as not to require any additional capital as a result of Solvency II.

ISBN 978-1-84532-466-7



9 781845 324667 >