

# Steve Dixon Associates Update

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## Prudential regulation

### *CP08/24 - Stress Testing*

The FSA have released a new consultation paper on Stress and Scenario Testing. This CP brings in changes in rules in GENPRU, BIPRU and INSPRU. The rule changes:

1. Bring in a new requirement on top of the ICA/ICAAP for a new stress test;
2. Clarify the latter parts of GENPRU 1.2 to show that the ICA / ICAAP is not sufficient in itself but firms need to stress their business plans over a three to five year period (at least).

The changes are a reaction to events over the last year and provide plenty of meat.

#### 1. New Test.

The FSA have introduced a new stress test / scenario test for all firms that you will be required to submit alongside your ICAS or ICAAP report. This is called a “reverse stress test” which is supposed to be a scenario that would show the failure of your business plan. Interestingly, the FSA do not require the reverse stress test to show the insolvency of the firm as the result of the stress. The firm arriving at a position where its counterparties lose “faith” with the firm and start terminating their contracts with the firm would be a sufficient point at which the reverse stress test could end.

The aim expressed by FSA is that firms who carried out reverse stress tests understood their risks better than firms that did not during the recent market turbulence and were able to react quicker and more effectively

to manage the situation. They believe that boards and senior management become practiced at dealing with the rogue events from the exercise of preparing a reverse stress test.

Obviously, it will allow the FSA greater insight into firms’ positions.

The new requirement will be in SYSC. This is strange as it now increases the handbooks that need to be referred to on prudential regulation.

The reverse stress test will need to be supplied alongside the ICA to the FSA.

The change to worry about failure of business model rather than insolvency is also new. The banks will have to worry about a loss of confidence in the bank by depositors.

#### 2. Clarify long term stress tests.

The changes clarify an existing requirement. All directive insurers are required to generate stress tests and scenarios applying to their business plans on a 3 to 5 year term at least. This is similar to the old Financial Condition Report in actuarial guidance.

The work will be for the Board and will not necessarily be disclosable. We suspect that ARROW visits will ask to see the report. Many insurers are already being asked to show these reports.

New to the rules is a requirement to project the Pillar 2 capital requirements. This means that your stressed business plan needs a calculation of future ICAs embedded within it. The FSA have stated that approximations can be used but need documenting.

#### 3. Other points.

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The CP clarifies the treatment of pension schemes in the ICA / ICAAP process. It states that the item to be stressed is not the solvency of the scheme but the likely call on employers' resources from the scheme through additional contributions. However, the stresses applied to the scheme should be of the same order as the stresses applied if the scheme's liabilities were on balance sheet when determining the likely impact on the contribution rates.

The CP outlines group risk considerations and adds group risk specifically to the list of risks to be considered.

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