

Chapter 20

Reverse stress testing

20.1 Application and purpose

Application

20.1.1 **R**

20.1.1A **R**

- (1) ■ SYSC 20 applies to:
- (a) an *IFPRU investment firm*; and
 - (b) a *BIPRU firm* which meets any of the criteria in (2) on an individual basis, or in (3) on a consolidated basis.
- (2) Subject to (4), ■ SYSC 20 applies to a *BIPRU firm* if:
- (a) it has assets under management or administration of at least £10 billion (or the equivalent amount in foreign currency); or
 - (b) the total annual fee and commission arising from regulated activities is at least £250 million (or the equivalent amount in foreign currency); or
 - (c) it has assets or liabilities of at least £2 billion (or the equivalent amount in foreign currency).
- (3) Subject to (4), where all of the *BIPRU firms* within the same *UK consolidation group* or the *non-UK sub-group*, taken together, as if they were one *firm*, meet any of the criteria in (2), ■ SYSC 20 applies to each of those *BIPRU firms* as if it individually met the criteria in (2).
- (4) Any *BIPRU firm* which is included within the scope of ■ SYSC 20 in accordance with (2) or (3) in any given year will continue to be subject to ■ SYSC 20 for the following two years, irrespective of whether or not it continues to meet the inclusion criteria in any of those subsequent years.

Purpose

20.1.2 **G**

This chapter amplifies *Principle 2*, under which a *firm* must conduct its business with due skill, care and diligence, and *Principle 3*, under which a *firm* must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.

20.1.3 **G**

This chapter contains *rules* on reverse stress testing, which require a *firm* to identify and assess events and circumstances that would cause its business model to become unviable. This chapter also requires the *firm's* senior management or *governing body* to review and approve the results of the

reverse stress testing exercise. This should help the *firm's* senior management to identify the *firm's* vulnerabilities and design a strategy to prevent or mitigate the risk of business failure.

- 20.1.4A** **G** The reverse stress testing requirements are an integral component of a *firm's* business planning and risk management under SYSC. For *IFPRU investment firms* as referred to in ■ SYSC 20.1.1AR (1)(a), this chapter amplifies ■ SYSC 7.1.1 G to ■ SYSC 7.1.8 G on risk control.

20.2 Reverse stress testing requirements

- 20.2.1** **R** As part of its business planning and risk management obligations under SYSC, a *firm* must reverse stress test its business plan; that is, it must carry out stress tests and scenario analyses that test its business plan to failure. To that end, the *firm* must:
- (1) identify a range of adverse circumstances which would cause its business plan to become unviable and assess the likelihood that such events could crystallise; and
 - (2) where those tests reveal a risk of business failure that is unacceptably high when considered against the *firm's* risk appetite or tolerance, adopt effective arrangements, processes, systems or other measures to prevent or mitigate that risk.
- 20.2.2** **R** Where the *firm* is a member of:
- (1) [deleted]
 - (2) a *UK consolidation group*; or
 - (3) a *non-UK sub-group*;
- it must conduct the reverse stress test on a solo basis as well as on a consolidated basis in relation to the *UK consolidation group* or the *non-UK sub-group*, as the case may be.
- 20.2.3** **R** The design and results of a *firm's* reverse stress test must be documented and reviewed and approved at least annually by the *firm's* senior management or *governing body*. A *firm* must update its reverse stress test more frequently if it is appropriate to do so in the light of substantial changes in the market or in macroeconomic conditions.
- 20.2.4** **G**
- (1) Business plan failure in the context of reverse stress testing should be understood as the point at which the market loses confidence in a *firm* and this results in the *firm* no longer being able to carry out its business activities. Examples of this would be the point at which all or a substantial portion of the *firm's* counterparties are unwilling to continue transacting with it or seek to terminate their contracts, or the point at which the *firm's* existing shareholders are unwilling to

provide new capital. Such a point may be reached well before the *firm's* financial resources are exhausted.

- (2) The *appropriate regulator* may request a *firm* to quantify the level of financial resources which, in the *firm's* view, would place it in a situation of business failure should the identified adverse circumstances crystallise.
- (3) In carrying out the stress tests and scenario analyses required by ■ SYSC 20.2.1 R, a *firm* should at least take into account each of the sources of risk identified in accordance with ■ GENPRU 1.2.30R (2).

20.2.5 **G** Reverse stress testing should be appropriate to the nature, size and complexity of the *firm's* business and of the risks it bears. Where reverse stress testing reveals that a *firm's* risk of business failure is unacceptably high, the *firm* should devise realistic measures to prevent or mitigate the risk of business failure, taking into account the time that the *firm* would have to react to these events and implement those measures. As part of these measures, a *firm* should consider if changes to its business plan are appropriate. These measures, including any changes to the *firm's* business plan, should be documented as part of the results referred to in ■ SYSC 20.2.3 R.

20.2.6 **G** In carrying out its reverse stress testing, a *firm* should consider scenarios in which the failure of one or more of its major counterparties or a significant market disruption arising from the failure of a major market participant, whether or not combined, would cause the *firm's* business to fail.

20.2.7 **G**

- (1) The *appropriate regulator* may request a *firm* to submit the design and results of its reverse stress tests and any subsequent updates as part of its risk assessment.
- (2) In the light of the results of a *firm's* reverse stress tests, the *appropriate regulator* may require the *firm* to implement specific measures to prevent or mitigate the risk of business failure where that risk is not sufficiently mitigated by the measures adopted by the *firm* in accordance with ■ SYSC 20.2.1 R, and the *firm's* potential failure poses an unacceptable risk to the *appropriate regulator's* statutory objectives.
- (3) The *appropriate regulator* recognises that not every business failure is driven by lack of financial resources and will take this into account when reviewing a *firm's* reverse stress test design and results.

