FSA 2001/36

INTERIM PRUDENTIAL SOURCEBOOK FOR INSURERS (AMENDMENT) INSTRUMENT 2001

A. The Financial Services Authority amends the Interim Prudential Sourcebook for Insurers in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 (the "Act"):

(a) section 138 (general rule making power);

(b) section 141 (insurance business rules);

(c) section 150(2) (actions for damages);

(d) section 156 (general supplementary powers);

(e) section 157 (guidance); and

(f) section 340 (appointment of auditors and actuaries).

B. The provisions of the Act relevant to making rules and listed above are specified for the purpose of section 153(2) of the Act (Rule-making instruments).

C. This instrument comes into force immediately.

D. IPRU(INS) is amended:

(1) in accordance with Annex A to this instrument;

(2) by suspending DAA14 in volume 3 until 1 June 2002; and

(3) by adding DAA15 (as set out in Annex B to this instrument) at the end of volume 3 for temporary period until 31 May 2002.

E. This instrument may be cited as the Interim Prudential Sourcebook for Insurers (Amendment) Instrument 2001.

By order of the Board
20 September 2001

Annex A

1. For part (a) of the definition of *participation* in rule 11.1 substitute the following:

"(a) the holding of a participating interest within the meaning of section 421(2) of the *Act*; or"

2. For rule 10.(2)(4) substitute the following:

"(4) The declaration required by (1):

(a) must be made in writing and deposited with the FSA at the same time as the documents required by rules 9.3 and 9.4;

(b) must be signed by the persons described in rule 9.33(1)(a); and

(c) must include a statement from the auditors that, in their opinion, it has been properly compiled in accordance with rule 10.2 from information provided to the *insurer* by other members of the *insurance group* and from the *insurer's* own records."

3. For part (b) of the definition of *long-term insurance business amount* in rule 11.1 substitute the following:

"(b) such other amount as the *insurer* may select not exceeding the value of its assets (other than *general insurance business assets* if the *insurer* is a *general insurer* and excluding *reinsurance recoveries* and assets required to match *property linked liabilities*) in accordance with the *Valuation of Assets Rules,*"

4. For the first paragraph of the definition of *contract for differences* in rule 11.1 substitute the following:

"a contract for differences or any other contract the purpose or pretended purpose of which is to secure a profit or avoid a loss by reference to fluctuations in-"

5. For the last paragraph of the definition of *non-directive insurer* in rule 11.1 substitute the following:

> "whose *insurance business* is limited to that described in paragraphs (1) to (7)"

6. For rule 10.1 substitute the following:

> "10.1 This chapter applies to an *insurer* (other than a *pure reinsurer*) that is a *subsidiary undertaking* of an *ultimate insurance parent undertaking* and whose head office is in the United Kingdom."

Direct line:
Local fax:
Email:

10 September 2001

Our Ref: DAA15

Your Ref:

Dear Appointed Actuary

Resilience Test

As you will be aware, Regulation 75 of the determination of liability regulations in the Insurance Companies Regulations 1994 requires prudent provision to be made against the effects of possible future changes in the value of assets on the adequacy of these assets to meet the liabilities. This regulation is being carried forward, from 1 December 2001, in Rule 5.17 of the Interim Prudential Sourcebook for Insurers.

Guidance on how Appointed Actuaries should interpret this regulation has, in the past, been given in letters from the Government Actuary, which give advice on how this so-called 'resilience test' should be applied. These letters explain that actuaries should consider a range of possible financial conditions in the future, and the extent to which the solvency margin should be viewed as sufficient to enable the office to meet its liabilities in such circumstances. The present guidance is in the Government Actuary's letter (DAA14) dated 14 May 2000.

This concept of resilience testing is of course fully consistent with the proposed new regime for all financial institutions, as set out in our recent consultation document on the Integrated Prudential Sourcebook, CP97. This document envisages that there should be appropriate judgement by each firm of the financial scenarios to be considered for this purpose, taking account of the nature of the assets and liabilities of the firm as well as perceptions of potential market movements. Accordingly, we consider that this element of the guidance is the key aspect on which attention should now be focused.

The Financial Services Authority is authorised to exercise functions of the Treasury under insurance legislation, pursuant to the Contracting Out (Functions in Relation to Insurance) Order 1998

The present guidance sets out three specific possible future scenarios, each of which should be tested by the actuary in his or her resilience test. These scenarios have been developed and modified over the last ten years to reflect changing perceptions of the range of investment scenarios that could arise, and changes to the regulations. Since we are now operating in a low inflationary environment in which a significant rise in interest rates on fixed interest securities is considerably less likely, the FSA considers that the test set out in the present scenario three appears unrealistic. (In the possible converse scenario, the present rules for valuing liabilities do of course already make proper allowance for possible falls in the yield on fixed-interest securities.)

Accordingly, in the light of all the above considerations, the FSA has decided that the guidance should be modified and simplified so that, in place of the present recommended set of scenarios for the resilience test, the actuary should, as a minimum, consider the scenario of a fall in the value of equities of the greater of

(a) 25%, subject to the fall being restricted to such as would not produce a P/E ratio on the FTSE Actuaries All Share Index lower than 75% of the inverse of the long term gilt yield (as defined in regulation 69 of the Insurance companies Regulations 1994 and rule 5.11 of the Interim Prudential Sourcebook for Insurers), and

(b) 10%.

At the same time, the actuary should make the prudent assumption that company earnings might fall by 10% (shortly after the above fall in equity values), but that dividends would remain unaltered when assessing the corresponding rate of interest at which the liabilities should be valued.

The actuary would then be expected to apply his or her own professional judgement in considering the level of changes in the value of other types of investment held by the insurer for the purpose of this resilience test. Naturally the prudence concept must be paramount. Reductions in fixed interest yields, and/or the reversion of the current yield curve to a more normal shape, are among the obvious possibilities.

The actuary should also take account of the nature of the assets and liabilities. For example the actuary to an insurer which has only unit linked business, some of which carries a guaranteed annuity rate, should not necessarily assume equity values fall in applying tests for lower fixed interest rates. Indeed actuaries to such insurers should consider their resilience to a rise in equity values combined with falling interest rates.

The above text replaces with immediate effect the guidance in the Government Actuary's letter DAA14. This guidance is also given under section 157 of the Financial Services and Markets Act 2000 and, on a temporary basis until 31 May 2002, replaces that contained in the Interim Prudential Sourcebook for Insurers as DAA14 in Volume 3. After 31 May 2002, this guidance will lapse or (following consultation) become permanent guidance. This temporary

guidance has been given without consultation because the FSA considers that the delay involved in consulting would be prejudicial to the interests of consumers. The FSA will make a further announcement about this guidance when it is appropriate to do so. In the meantime, the FSA expects actuaries to apply the above principles when monitoring and assessing the ongoing financial condition of their firms.

We would also of course expect that actuaries will continue to investigate a wide range of possible future investment scenarios for the purpose of reporting to their boards on their stress testing of the firm. As I am sure you will be aware, we are likely to ask to see a copy of these reports from time to time as part of our ongoing supervision of firms.

Yours sincerely

T W Hewitson
Head of Actuarial Department
Financial Services Authority