Powers exercised

A. The Financial Services Authority makes this instrument in the exercise of:

   (1) 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 150(2) (Actions for damages);
      (c) section 156 (General supplementary powers); and
      (d) section 157(1) (Guidance); and

   (2) the other powers and related provisions listed in Schedule 4 (Powers exercised) to the General Provisions of the Handbook.

B. The rule-making powers referred to above are specified for the purpose of section 153(2) (Rule-making instruments) of the Act.

Commencement


Amendments to the Handbook

D. The modules of the FSA’s Handbook of rules and guidance listed in column (1) below are amended in accordance with the Annexes to this instrument listed in column (2).

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Citation

E. This instrument may be cited as the Prudential Requirements (Stress Testing) Instrument 2009.

By order of the Board
10 December 2009
Annex A

Amendments to the Glossary of definitions

In this Annex, underlining indicates new text.

**Part 1: Comes into force on 14 December 2009**

*group* …

(3) (for the purposes of SYSC 12 (Group risk systems and controls requirement) and GENPRU 1.2 (Adequacy of financial resources) and in relation to a *person “A”*) A and any *person*:

(a) who falls into (1);

(b) who is a member of the same *financial conglomerate* as A;

(c) who has a *consolidation Article 12(1) relationship* with A;

(d) who has a *consolidation Article 12(1) relationship* with any *person* in (3)(a);

(e) who is a *subsidiary undertaking* of a person in (3)(c) or (3)(d); or

(f) whose omission from an assessment of the risks to A of A’s connection to any *person* coming within (3)(a)-(3)(e) or an assessment of the financial resources available to such *persons* would be misleading.

…
(3) (for the purposes of SYSC 12 (Group risk systems and controls requirement), SYSC 20 (Reverse stress testing) and GENPRU 1.2 (Adequacy of financial resources) and in relation to a person “A”)) A and any person:

(a) who falls into (1);

(b) who is a member of the same financial conglomerate as A;

(c) who has a consolidation Article 12(1) relationship with A;

(d) who has a consolidation Article 12(1) relationship with any person in (3)(a);

(e) who is a subsidiary undertaking of a person in (3)(c) or (3)(d); or

(f) whose omission from an assessment of the risks to A of A’s connection to any person coming within (3)(a)-(3)(e) or an assessment of the financial resources available to such persons would be misleading.
Annex B

Amendments to the Senior Management Arrangements, Systems and Controls sourcebook (SYSC)

In this Annex, underlining indicates new text and striking through indicates deleted text, unless otherwise stated.

Part 1: Comes into force on 14 December 2009

12.1.9 G For the purposes of SYSC 12.1.8R, the question of whether the risk management processes and internal control mechanisms are adequate, sound and appropriate should be judged in the light of the nature, scale and complexity of the group’s business and of the risks that the group bears. Risk management processes must include the stress testing and scenario analysis required by GENPRU 1.2.42R and GENPRU 1.2.49R(1)(b).

Part 2: Comes into force on 14 December 2010

7.1.4A G Other firms should take account of the risk management rules (SYSC 7.1.3R and SYSC 7.1.4R) as if they were guidance (and as if "should" appeared in those rules instead of "must") as explained in SYSC 1 Annex 1.3.3G.

For a common platform firm included within the scope of SYSC 20 (Reverse stress testing), the strategies, policies and procedures for identifying, taking up, managing, monitoring and mitigating the risks to which the firm is or might be exposed include conducting reverse stress testing in accordance with SYSC 20. A common platform firm which falls outside the scope of SYSC 20 should consider conducting reverse stress tests on its business plan as well. This would further senior personnel’s understanding of the firm’s vulnerabilities and would help them design measures to prevent or mitigate the risk of business failure.

7.1.4B G Other firms should take account of the risk management rules (SYSC 7.1.3R and SYSC 7.1.4R) as if they were guidance (and as if "should" appeared in those rules instead of "must") as explained in SYSC 1 Annex 1.3.3G.

After SYSC 19, insert the following new chapter. The text is not underlined.

20 Reverse stress testing

20.1 Application and purpose

Application

20.1.1 R (1) SYSC 20 applies to:
(a) a BIPRU firm, unless it is a BIPRU investment firm excluded in accordance with (2); and

(b) an insurer unless it is:
   (i) a non-directive friendly society; or
   (ii) a Swiss general insurer; or
   (iii) an EEA-deposit insurer; or
   (iv) an incoming EEA firm; or
   (v) an incoming Treaty firm.

(2) Subject to (3) and (4), a BIPRU investment firm is excluded from the scope of SYSC 20 if:

(a) where it carries out the regulated activity of managing investments or safeguarding and administering investments, it has assets under management or administration of no more than £10 billion (or the equivalent amount in foreign currency); or

(b) the total annual fee and commission income arising from its regulated activities is no more than £250 million (or the equivalent amount in foreign currency); or

(c) it has assets and liabilities of no more than £2 billion (or the equivalent amount in foreign currency).

(3) In order to determine whether a BIPRU investment firm is excluded from the scope of SYSC 20, the exclusion criteria in (2) apply on a consolidated basis to all of the BIPRU investment firms within the same UK consolidation group or non-EEA sub-group as if they were one firm.

(4) Any BIPRU investment firm which is not excluded in accordance with (2) and (3) in any given year will continue to be subject to SYSC 20 for the following two years irrespective of whether it satisfies the criteria to be excluded in any of those subsequent years.

Purpose

20.1.2 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.

20.1.4 G The reverse stress testing requirements are an integral component of a firm’s business planning and risk management under SYSC. For BIPRU firms as referred to in SYSC 20.1.1R(1)(a), this chapter amplifies SYSC 7.1.1G to SYSC 7.1.8G on risk control. For insurers as referred to in SYSC 20.1.1R(1)(b), this chapter amplifies SYSC 14.1.17G to SYSC 14.1.25G on business planning and risk management.

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. an insurance group, in respect of which it is required to maintain group capital;

2. a UK consolidation group; or

3. a non-EEA sub-group;

it must conduct the reverse stress test on a solo basis as well as on a consolidated basis in relation to the insurance group, the UK consolidation group or the non-EEA 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 FSA 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 20.2.1R, 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 20.2.3R.

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 FSA may request a firm to submit the design and results of its reverse stress tests and any subsequent updates as part of its ARROW risk assessment.

(2) In the light of the results of a firm’s reverse stress tests, the FSA 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 20.2.1R, and the firm’s potential failure poses an unacceptable risk to the FSA’s statutory objectives.
(3) The FSA 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.
Annex C

Amendments to the General Prudential sourcebook (GENPRU)

In this Annex, underlining indicates new text and striking through indicates deleted text.

Part 1: Comes into force on 14 December 2009

1.2.27 G The liabilities referred to in the overall financial adequacy rule include a firm’s contingent and prospective liabilities. It excludes liabilities that might arise from transactions that a firm has not entered into and which it could avoid, for example, by ceasing to trade taking realistic management actions such as ceasing to transact new business after a suitable period of time has elapsed. It includes liabilities or costs that arise as a consequence of strategies other than continuing as both in scenarios where the firm is a going concern and those where the firm ceases to be a going concern. It also includes claims that could be made against a firm, which ought to be paid in accordance with fair treatment of customers, even if such claims could not be legally enforced.

Systems, strategies, processes and reviews

1.2.30 R A firm must have in place sound, effective and complete processes, strategies and systems:

…

(2) that enable it to identify and manage the major sources of risks referred to in (1), including the major sources of risk in each of the following categories where they are relevant to the firm given the nature and scale of its business:

…

(j) interest rate risk (including in the case of a BIPRU firm, interest rate risk in the non-trading book); and

(k) pension obligation risk; and

(l) group risk.

…

1.2.32 G (1) This paragraph gives guidance on some of the terms used in the overall Pillar 2 rule.

…
(6) Group risk is the risk that the financial position of a firm may be adversely affected by its relationships (financial or non-financial) with other entities in the same group or by risks which may affect the financial position of the whole group, for example reputational contagion. Further guidance on group risk can be found in GENPRU 1.2.87G to GENPRU 1.2.91G.

...  

1.2.37 R The processes and systems required by the overall Pillar 2 rule must:

(1) include an assessment of how it the firm intends to deal with each of the major sources of risk identified in accordance with GENPRU 1.2.30R(2); and

(2) take into account the impact of diversification effects and how such effects are factored into the firm’s systems for measuring and managing risks; and

(3) include an assessment of the firm-wide impact of the risks identified in accordance with GENPRU 1.2.30R(2), to which end a firm must aggregate the risks across its various business lines and units, making appropriate allowance for the correlation between risks.

...

Stress and scenario tests

1.2.42 R (1) As part of its obligation under the overall Pillar 2 rule, a firm must, for each of the major sources of risk identified in accordance with GENPRU 1.2.30 R(2), carry out stress tests and scenario analyses that are appropriate to the nature, scale and complexity of those major sources of risk and to the nature, scale and complexity of the firm’s business, as part of which the firm must:

(a) take reasonable steps to identify an appropriate range of realistic adverse circumstances and events in which the risk identified crystallises; and

(b) estimate the financial resources the firm would need in each of the circumstances and events considered in order:

(i) to be able to meet its liabilities as they fall due;

(ii) to be able to meet the CRR;

(iii) to carry out the plans referred to in GENPRU 1.2.37R (1); and

(iv) otherwise to meet, to the extent that it considers necessary, that major source of risk.
In carrying out the stress tests and scenario analyses in (1), a BIPRU firm with an IRB permission must incorporate and take into account the stress tests required to be carried out under BIPRU 4.3.39R to BIPRU 4.3.40R (Stress tests used in assessment of capital adequacy) identify an appropriate range of adverse circumstances of varying nature, severity and duration relevant to its business and risk profile and consider the exposure of the firm to those circumstances, including:

(a) circumstances and events occurring over a protracted period of time;

(b) sudden and severe events, such as market shocks or other similar events; and

(c) some combination of the circumstances and events described in (a) and (b), which may include a sudden and severe market event followed by an economic recession.

In carrying out the stress tests and scenario analyses in (1), the firm must incorporate and take into account any other stress tests and scenario analyses that it is required to carry out under any other provision of the Handbook. In carrying out the stress tests and scenario analyses in (1), the firm must estimate the financial resources that it would need in order to continue to meet the overall financial adequacy rule and the CRR in the adverse circumstances being considered.

In carrying out the stress tests and scenario analyses in (1), the firm must assess how risks aggregate across business lines or units, any material non-linear or contingent risks and how risk correlations may increase in stressed conditions.

As part of its obligation under the overall Pillar 2 rule, a BIPRU firm must also incorporate and take into account any stress tests and scenario analyses that it is required to carry out under BIPRU. In particular, a BIPRU firm with an IRB permission must incorporate and take into account the stress test required to be carried out under BIPRU 4.3.40R(2).

In order to comply with the general stress and scenario testing rule, a firm should undertake a broad range of stress tests which reflect a variety of perspectives, including sensitivity analysis, scenario analysis and stress testing on an individual portfolio as well as a firm-wide level.

A BIPRU firm with an IRB permission which has any material credit exposures excluded from its IRB models should also include these exposures in its stress and scenario testing to meet its obligations under the general stress and scenario testing rule. A BIPRU firm without an IRB permission, or an insurer that has any material credit and counterparty credit risk exposures, should conduct analyses to assess risks to the credit quality of its
counterparties, including any protection sellers, considering both on and off-balance sheet exposures.

1.2.42C G An insurer may choose to carry out its ICA through the use of stress testing and scenario analyses (see INSPRU 7.1.10G and INSPRU 7.1.68G). If it does so, in carrying out the stress tests and scenario analyses referred to in GENPRU 1.2.42R, an insurer should take into account the stress tests it uses for its ICA.

1.2.42D G In carrying out the stress tests and scenario analyses required by GENPRU 1.2.42R(1), a firm should also consider any impact of the adverse circumstances on its capital resources. In particular, a firm should consider the capital resources gearing rules where its tier one capital is eroded by the event.

1.2.42E G A firm should assign adequate resources, including IT systems, to stress testing and scenario analysis, taking into account the stress testing techniques employed, so as to be able to accommodate different and changing stress tests at an appropriate level of granularity.

1.2.42F G GENPRU 1.2.63G to GENPRU 1.2.78G provide additional guidance on stress testing and scenario analyses. In particular, GENPRU 1.2.73AG provides specific guidance on capital planning.

Documentation of risk assessments

1.2.60 R A firm must make a written record of the assessments required under this section. These assessments include assessments carried out on a consolidated basis and on a solo basis. In particular, it must make a written record of:

... (3) details of the stress tests and scenario analyses carried out, including any assumptions made in relation to scenario design, and the resulting financial resources estimated to be required in accordance with the general stress and scenario testing rule.
Additional guidance on stress tests and scenario analyses

1.2.63 G The general stress and scenario testing rule requires a firm to carry out stress tests and scenario analyses as part of its obligations under the overall Pillar 2 rule. Both stress tests and scenario analyses can be undertaken by a firm to further a better understanding of the vulnerabilities that it faces under extreme adverse conditions. They are based on the analysis of the impact of unlikely, but not impossible, events a range of events of varying nature, severity and duration. These events can be financial, operational or legal or relate to any other risk that might have an economic impact on the firm.

... 

1.2.67 G The general stress and scenario testing rule requires a firm, as part of carrying out stress tests and scenario analyses, to take reasonable steps to identify an appropriate range of realistic circumstances and events in which a risk would crystallise. In particular:

(1) a firm need only carry out stress tests and scenario analyses in so far as the circumstances or events are reasonably foreseeable, that is to say, their occurrence is not too remote a possibility: and

(2) a firm should also take into account the relative costs and benefits of carrying out the stress tests and scenario analyses in respect the circumstances and events identified. [deleted]

... 

1.2.70 G Where a firm is exposed to market risk, the time horizon over which stress tests and scenario analysis analyses should be carried out should will depend on among other things, the maturity and liquidity of the positions stressed. For example, for the market risk arising from the holding of investments, this should will depend upon:

... 

(2) the extent to which the market in those assets is sufficiently liquid (and would remain liquid in the changed circumstances contemplated in the stress test or scenario analysis) to allow the firm, if needed, to sell, hedge or otherwise mitigate the risks relating to its holding so as to prevent or reduce exposure to future price fluctuations. In devising stress tests and scenario analyses for market risk, a BIPRU firm should also take into account BIPRU 7.1.17R to BIPRU 7.1.20G.

...

1.2.73 G (1) A firm should conduct stress tests and scenario analyses which project its financial position (both profitability and balance sheet
position) so as to estimate both its capital resources and capital resource requirements throughout an economic or business cycle.  

(1A) For an insurer, these tests and analyses are in addition to those that may be used for the ICA (see INSPRU 7.1.10G and INSPRU 7.1.68G). Projections should be made on different bases, including ones which are consistent with the business plan, as well as others using "realistically adverse" alternative scenarios. In considering the tests and analyses to be used for the purposes of these projections, an insurer should have regard to the matters mentioned below.

(a) As with the ICA, it is for the insurer to identify an appropriate range of adverse circumstances and events. As the projections are being assessed as part of business planning, the FSA would expect stresses and scenarios to be more likely than the extreme conditions covered by an ICA. As a guide, stresses and scenarios with a probability of once in a 25 year period would be useful as a reference when an insurer discusses projections of its financial position with the FSA (see also GENPRU 1.2.75G(3)).

(b) Business risk is likely to be a more significant feature in projecting an insurer’s financial position than in its ICA (see GENPRU 1.2.31R and GENPRU 1.2.32G).

(c) The treatment of new business is likely to be different for projecting an insurer’s financial position than in its ICA. In the former, this should be based on the firm’s business plan, but flexed to incorporate potential changes in trading conditions and strategy. In the latter, account should be taken of the effects of a closure to new business (see GENPRU 1.2.27G, GENPRU 1.2.73G(3) and INSPRU 7.1.16G to INSIPRU 7.1.19G).

(d) Methods that are more approximate than used for an ICA may be appropriate for projecting elements of an insurer’s financial position (e.g. the with-profits insurance capital component for realistic basis life firms).  

(2) A firm will need to consider the cycles it is most exposed to and whether these are general economic cycles or specific to particular markets, sectors or industries. The length of time over which such projections would be appropriate will therefore vary, but typically might be between three and five years. 

(3) The projections should be based on the firm’s business plan, but flexed to incorporate adverse trading conditions and any changes in strategy which the firm could and would take in response to those conditions.
Changes in strategy might be necessary for instance because capital needed to be able to continue its business at existing volumes is eroded. A firm may also alter its capital management strategy to restrict distributions of profits or to raise additional capital. The combined effect on capital and retained earnings should be estimated. A firm should document how it would react to such economic and business risks. [deleted]

The FSA will take the projections referred to in this paragraph and the plan referred to in (4) into account as part of its SREP. The purpose of examining them is to enable the FSA to judge, at an appropriate level of certainty, whether the firm will be able to meet its obligations throughout a recession. [deleted]

Capital planning

1.2.73A G (1) In identifying an appropriate range of adverse circumstances and events in accordance with GENPRU 1.2.42R(2):

(a) a firm will need to consider the cycles it is most exposed to and whether these are general economic cycles or specific to particular markets, sectors or industries;

(b) for the purposes of GENPRU 1.2.42R(2)(a), the amplitude and duration of the relevant cycle should include a severe downturn scenario based on forward looking hypothetical events, calibrated against the most adverse movements in individual risk drivers experienced over a long historical period;

(c) the adverse scenarios considered should in general be acyclical and, accordingly, the scenario should not become more severe during a downturn and less severe during an upturn. However, the FSA does expect scenarios to be updated with relevant new economic data on a pragmatic basis to ensure that the scenario continues to be relevant; and

(d) the adverse scenarios considered should reflect a firm’s risk tolerance of the adverse conditions through which it expects to remain a going concern.

(2) In making the estimate required by GENPRU 1.2.42R(3), a firm should project both its capital resources and its required capital resources over a time horizon of 3 to 5 years, taking account of its business plan and the impact of relevant adverse scenarios. In making the estimate, the firm should consider both the capital resources required to meet its CRR and the capital resources needed to meet the overall financial adequacy rule. The firm should make these projections in a manner consistent with its risk management processes and systems as set out in GENPRU 1.2.37R.
In projecting its financial position over the relevant time horizon, the firm should:

(a) reflect how its business plan would “flex” in response to the adverse events being considered, taking into account factors such as changing consumer demand and changes to new business assumptions;

(b) consider the potential impact on its stress testing of dynamic feedback effects and second order effects of the major sources of risk identified in accordance with GENPRU 1.2.30R(2);

(c) estimate the effects on the firm’s financial position of the adverse event without adjusting for management actions;

(d) separately, identify any realistic management actions that the firm could and would take to mitigate the adverse effects of the stress scenario; and

(e) estimate the effects of the stress scenario on the firm’s financial position after taking account of realistic management actions.

A firm should identify any realistic management actions intended to maintain or restore its capital adequacy. These could include ceasing to transact new business after a suitable period has elapsed, balance sheet shrinkage, restricting distribution of profits or raising additional capital. A firm should reflect management actions in its projections only where it could and would take such actions, taking account of factors such as market conditions in the stress scenario and any effects upon the firm’s reputation with its counterparties and investors. The combined effect on capital and retained earnings should be estimated. In order to assess whether prospective management actions in a stress scenario would be realistic and to determine which actions the firm would and could take, the firm should take into account any preconditions that might affect the value of management actions as risk mitigants and analyse the difference between the estimates in (3)(c) and (3)(e) in sufficient detail to understand the implications of taking different management actions at different times, particularly where they represent a significant divergence from the firm’s business plan.

The firm should document its stress testing and scenario analysis policies and procedures, as well as the results of its tests in accordance with GENPRU 1.2.60R. These records should be included within the firm’s ICAAP or ICA submission document.

The FSA will review the firm’s records referred to in (5) as part of its SREP. The purpose of examining these is to enable the FSA to judge whether a firm will be able to continue to meet its CRR and
the overall financial adequacy rule throughout the projection period.

(7) If, after taking account of realistic management actions, a firm’s stress testing management plan shows that the firm’s projected capital resources are less than those required to continue to meet its CRR or less than those needed to continue to meet the overall financial adequacy rule over the projection period, the FSA may require the firm to set out additional countervailing measures and off-setting actions to reduce such difference or to restore the firm’s capital adequacy after the stress event.

(8) The firm’s senior management or governing body should be actively involved and engaged in all relevant stages of the firm’s stress testing and scenario analysis programme. This would include establishing an appropriate stress testing programme, reviewing the programme’s implementation (including the design of scenarios) and challenging, approving and actioning the results of the stress tests.

(9) For an insurer:

(a) the treatment of new business when making capital projections is likely to be different from its ICA. In projecting its financial position, an insurer should take account of new business based on the firm’s business plan, but flexed to take account of potential changes in trading conditions and strategy. When assessing its current capital adequacy under its ICA, an insurer should take account of the effects of closure to new business (see GENPRU 1.2.27G, GENPRU 1.2.73AG(3) and (4) and INSPRU 7.1.16G to INSPRU 7.1.19G). Also, an insurer may use methods that are more approximate than used for its ICA (for example, in projecting the with-profits insurance capital component for realistic basis life firms and the capital resources needed to meet the overall financial adequacy rule); and

(b) where management discretion is exercised as a normal part of an insurer’s business (for example, in changing bonus rates or surrender values in accordance with the PPFM for with-profits business), under (3)(c) the insurer does not need to estimate the effect of an adverse event on its financial position without adjusting for such changes. However, the effect on the financial position of varying such actions should be estimated and understood.

1.2.73B G The FSA may formulate macroeconomic and financial market scenarios which a firm may use as an additional input to its ICAAP or ICA submission. In addition, the FSA may also ask a firm to apply specific scenarios directly in its ICAAP or ICA submission.
1.2.75 G (1) A firm should assess the nature and severity of the economic recession or business cycle changes which are relevant to it given the nature and scale of its business. When projecting its capital resources and CRR, a firm should consider a range of stresses and scenarios both in nature and severity. [deleted]

(2) Stress and scenario analyses should, in the first instance, be aligned with the risk appetite of the firm, as well as the nature, scale and complexity of its business and of the risks that it bears, and the calibration of such the stress and scenario analyses should be reconciled back to a clear statement setting out the premise upon which the firm’s internal capital assessment under the overall Pillar 2 rule is based.

(3) A firm with an IRB permission should ensure that the range of stresses and scenarios considered encompasses the severity of recession specified in BIPRU 4.3.40R (Stress tests used in assessment of capital adequacy), which is one that might be expected to occur once in a 25 year period. Other firms may also find that this is a useful reference point when discussing their assessments with the FSA. [deleted]

(4) …

…

Pension obligation risk

1.2.79 G GENPRU 1.2.80G = to GENPRU 1.2.86G contain guidance on the assessment required by GENPRU 1.2.30R(2)(k) (Pension risk) for a firm exposed to pension obligation risk as defined in GENPRU 1.2.31R(5).

1.2.80 G The pension scheme itself (i.e. the scheme’s assets and liabilities) is not the focus of the risk assessment; but rather it is the firm’s obligations towards the pension scheme which is. A firm should include in its estimate of financial resources both its expected obligations to the pension scheme and any increase in obligations that may arise in a stress scenario.

…

1.2.82 G A firm should also assess the risks that may increase its current funding obligations towards the pension scheme and that might lead to the firm not being able to pay its other liabilities as they fall due.

…

1.2.83A G A firm is expected to determine where the scope of any stress test impacts upon its pension obligation risk and estimate how the relevant measure of
pension obligation risk will change in the scenario in question. For example, in carrying out stress tests under GENPRU 1.2.42R a firm must consider how a stress scenario, such as an economic recession, would impact on the 
firm’s current obligations towards its pension scheme and any potential increase in those obligations. Risks such as interest rate risk or reduced investment returns may have a direct impact on a firm’s financial position as well as an indirect impact resulting from an increase in the firm’s pension scheme obligations. Both effects should be taken into account in a firm’s estimate of financial resources under GENPRU 1.2.30R.

... 

Group risk

1.2.87 G GENPRU 1.2.88G to GENPRU 1.2.91G contain additional guidance on the assessment required by GENPRU 1.2.30R(2)(l) (Group risk).

1.2.88 G A firm should include in the written record referred to in GENPRU 1.2.60R a description of the broad business strategy of the insurance group, the UK consolidation group or the non-EEA sub-group of which it is a member, the group’s view of its principal risks and its approach to measuring, managing and controlling the risks. This description should include the role of stress testing, scenario analysis and contingency planning in managing risk at the solo and consolidated level.

1.2.89 G A firm should satisfy itself that the systems (including IT) of the insurance group, the UK consolidation group or the non-EEA sub-group of which it is a member are sufficiently sound to support the effective management and, where applicable, the quantification of the risks that could affect the insurance group, the UK consolidation group or the non-EEA sub-group, as the case may be.

1.2.90 G In performing stress tests and scenario analyses, a firm should take into account the risk that its group may have to bring back on to its consolidated balance sheet the assets and liabilities of off-balance sheet entities as a result of reputational contagion, notwithstanding the appearance of legal risk transfer.

1.2.91 G A firm should carry out stress tests and scenario analyses to a degree of sophistication which is commensurate with the complexity of its group and the nature of its group risk.
Part 2: Comes into force on 14 December 2010

1.2.75  G  (1)  …

…

(4)  A firm may also consider scenarios in which the amount of capital it currently holds would be exhausted. This would provide useful information about the reasonableness or remoteness of such scenarios arising. Where a firm uses capital models as part of its risk management processes, considering the sensitivity of model results to variations around the most likely ruin scenario focuses testing on the most relevant scenarios. In identifying adverse circumstances and events in accordance with GENPRU 1.2.42R(2), a firm should consider the results of any reverse stress testing conducted in accordance with SYSC 20. Reverse stress testing may be expected to provide useful information about the firm’s vulnerabilities and variations around the most likely ruin scenarios for the purpose of meeting the firm’s obligations under GENPRU 1.2.42R. In addition, such a comparison may help a firm to assess the sensitivity of its financial position to different stress calibrations.
Annex D

Amendments to the Prudential sourcebook for
Banks, Building Societies and Investment Firms (BIPRU)

In this Annex, underlining indicates new text and striking through indicates deleted text.

2.2.16 G If the FSA gives individual capital guidance to a firm, the FSA will state what amount and quality of capital the FSA considers the firm needs to hold in order to comply with the overall financial adequacy rule. It will generally do so by saying that the firm should hold capital resources of an amount which is at least equal to a specified percentage of that firm’s capital resources requirement. Such amount should be sufficient to enable the firm to continue to meet the overall financial adequacy rule in the face of the adverse circumstances and events to which GENPRU 1.2.42R(2) refers, taking account of any risk mitigation available to the firm.

…

2.2.25 G (1) This paragraph applies to a small firm whose activities are simple and primarily not credit-related.

…

(4) A firm should conduct stress tests and scenario analyses in accordance with GENPRU 1.2.42R to assess how that firm’s capital and CRR would alter and what that firm’s reaction might be to a range of adverse scenarios, including operational and market events. Where relevant, a firm should also consider the impact of an a severe economic or industry downturn on its future earnings, capital resources and capital resources requirement, taking into account its business plans. The downturn scenario should be based on forward looking hypothetical events calibrated against the most adverse movements in individual risk drivers experienced over a long historical period.

2.2.26 G In relation to a firm whose activities are moderately complex, in carrying out its ICAAP, BIPRU 2.2.25G(3) to (4) apply. In addition, it could:

…

(7) assume that business does not develop as expected and consider how that firm’s capital and CRR would alter and what that firm’s reaction to a range of adverse economic scenarios might be (see GENPRU 1.2.30R to GENPRU 1.2.43G (the overall Pillar 2 rule and related rules and guidance)). Where appropriate, the adverse scenarios should consider the impact of market events that are instantaneous or occur over an extended period of time but which are nevertheless still co-dependent on movements in economic conditions;
2.2.40 G To assess its expected capital requirements over the economic and business cycles, a firm may wish to project forward its financial position taking account of its business strategy and expected growth according to a range of assumptions as to the state of the economic or business environment which it faces. For example, an ICAAP should include an analysis of the impact that the actions of a firm's competitors might have on its performance, in order to see what changes in its environment the firm could sustain. Projections over a three to five year period would be appropriate in most circumstances. A firm may then calculate its projected CRR and assess whether it could be met from expected financial resources. Additional guidance on capital planning over an economic and business cycle can be found in GENPRU 1.2.73AG (Capital planning).

2.2.44 G If a firm's current available capital resources are less than the capital resources requirement indicated by the stress test that need not be a breach of BIPRU 2.2.41R. The firm may wish to set out any countervailing effects and off-setting actions that can be demonstrated to the satisfaction of the FSA as being likely to reduce the difference referred to in the first sentence. The FSA is only likely to consider a demonstration of such actions as credible if those actions are set out in a capital management plan based on the procedures in GENPRU 1.2.73G (Stress tests and scenario analyses throughout an economic or business cycle) 1.2.73AG (Capital planning) and including a plan of the type referred to in GENPRU 1.2.73G(4) 1.2.73AG(5) that has been approved by the firm's senior management or governing body.

2.3.9 G For a larger and/or more complex firm, appropriate systems to evaluate and manage interest rate risk in the non-trading book may include:

(1) the ability to measure the exposure and sensitivity of the firm's activities, if material, to repricing risk, yield curve risk, basis risk and risks arising from embedded optionality (for example, pipeline risk, prepayment risk) as well as changes in the shape of the yield curve, changes between different market rates (i.e. basis risk) and changes to assumptions (for example, those about customer behaviour);

4.3.39A G The FSA expects that firms will routinely make use of stress testing and scenario analysis as a tool in the calibration and/or validation of their IRB
approach parameters in order to increase the accuracy or, at least, the conservatism of the estimates. Stress testing should include a thorough exploration of various outturns different to the firm’s normal expectations in order to give the firm a clear view of the potential for the forward-looking estimate to be different from that indicated by the primary data source(s). Firms should consider this as an integral part of their quantification process, and should have clear standards for how the results of the stress tests affect the final estimates used for the IRB approach parameters.

4.3.40 R …

(2) The stress test must be designed to assess the firm’s ability to meet its capital requirements for credit risk under GENPRU 2.1 during all stages of the economic cycle and during an economic recession such as might be experienced once in 25 years downturn scenario based on forward looking hypothetical events calibrated against the most adverse movements in individual risk drivers experienced over a long historical period.

…

5.2.9 R A firm must be able to satisfy the FSA that it has adequate risk management processes to control those the risks to which the firm may be exposed as a result of carrying out credit risk mitigation. Those processes must include appropriate stress tests and scenario analyses relating to those risks, including residual risk and the risks relating to the intrinsic value of the credit risk mitigation.

[Note: BCD Annex VIII Part 2 point 1]

…

5.4.53 R A firm must take into account the illiquidity of lower-quality assets. The liquidation period must be adjusted upwards in cases where there is doubt concerning the liquidity of the collateral. A firm must also identify where historical data may understate potential volatility, e.g. a pegged currency. Such cases must be dealt with by means of a stress scenario assessments.

…

5.6.19A G This paragraph provides guidance in relation to BIPRU 5.6.19R(8). In carrying out the stress testing programme, a firm should evaluate the simultaneous impact of individual stress scenarios on its counterparty exposures, its positions and the aggregate amount of margin calls that it would receive. A firm’s stress scenarios should take into account the possibility that the liquidation period may be substantially longer than 5 days for repurchase transactions and securities lending or borrowing transactions, and 10 days for other types of securities financing transactions.
Stress testing and scenario analyses of trading book positions

7.1.17 R A firm must conduct a regular programme of stress testing and scenario analysis of its trading book positions, both at the trading desk level and on a firm-wide basis. The results of these tests must be reviewed by senior management and reflected in the policies and limits the firm sets.

7.1.17A G The firm’s stress testing programme should be comprehensive in terms of both risk and firm coverage, and appropriate to the size and complexity of trading book positions held.

7.1.18 R In carrying out the stress tests and scenario analyses required by BIPRU 7.1.17R, a firm must incorporate and take into account any other relevant stress tests and scenario analyses that it is required to carry out under any other provision of the Handbook, and in particular under BIPRU 7.10.72R where the firm has a VaR model permission.

7.1.19 G This paragraph gives guidance in relation to the stress testing programme that a firm must carry out in relation to its trading book positions.

(1) The frequency of the stress testing of trading book positions should be determined by the nature of the positions.

(2) The stress testing should include shocks which reflect the nature of the portfolio and the time it could take to hedge out or manage risks under severe market conditions.

(3) The firm should have procedures in place to assess and respond to the results of the stress testing programme. In particular, stress testing should be used to evaluate the firm’s capacity to absorb losses or to identify steps to be taken by the firm to reduce risk.

(4) As part of its stress testing programme, the firm should consider how prudent valuation principles (see GENPRU 1.3) will be met in a stressed scenario.

7.1.20 G The stress testing and scenario analysis under BIPRU 7.1.17R should be taken into account under the overall Pillar 2 rule.

Risk management standards: Stress testing

7.10.72 R (1) A firm must frequently conduct a rigorous programme of stress testing. The results of these tests must be reviewed by senior management and reflected in the policies and limits the firm sets.

(2) The programme must particularly address:
... 

(g) ...; and

(h) other risks that may not be captured appropriately in the VaR model (for example, recovery rate uncertainty, implied correlations and skew risk) full revaluation, or a reliable approximation, of positions;

(i) instant shocks as well as effects of longer term periods of stress;

(j) calibration changes under stressed conditions;

(k) secondary risk factors (such as volatility);

(l) basis risk;

(m) systemic and localised stresses; and

(n) other risks that may not be captured appropriately in the VaR model (for example, recovery rate uncertainty, implied correlations and skew risk).

... 

7.10.73A G The firm’s stress testing programme should be comprehensive in terms of both risk and firm coverage, and appropriate to the size and complexity of trading book positions held.

... 

9.1.8A G (1) The FSA expects firms to conduct regular stress testing in relation to their securitisation activities and off-balance sheet exposures. The stress tests should consider the firm-wide impact of those activities and exposures in stressed market conditions and the implications for other sources of risk, for example, credit risk, concentration risk, counterparty risk, market risk, liquidity risk and reputational risk. Stress testing of securitisation activities should take into account both existing securitisations and pipeline transactions, as there is a risk that these would not be completed in a stressed market scenario.

(2) The frequency and extent of the stress testing should be determined by the materiality of the firm’s securitisation activities and off-balance sheet exposures.

(3) A firm should have procedures in place to assess and respond to the results produced from the stress testing and these should be taken into account under the overall Pillar 2 rule.
Annex E

Amendments to the Prudential sourcebook for Insurers (INSPRU)

In this Annex, underlining indicates new text and striking through indicates deleted text.

7.1.9A  G  This section sets out in greater detail the approach to be taken by a firm when carrying out the assessment of capital described in the preceding paragraph. This is the assessment referred to as an individual capital assessment. The rules in GENPRU 1.2 also (see GENPRU 1.2.30R (1)(e)) require a firm to identify and assess risks to its being able to meet its CRR in the future. GENPRU 1.2.42R is a general requirement for a firm to carry out stress tests and scenario analyses taking into account an appropriate range of adverse circumstances and events relevant to the firm’s business and risk profile and to estimate the financial resources it would need to continue to meet the overall financial adequacy rule in the stress scenarios considered. As part of its obligations under GENPRU 1.2.42R, the firm must carry out stress tests and scenario analyses to estimate the financial resources it would need to support its business plans and continue adequately to cover its CRR and meet the overall financial adequacy rule over a time horizon of 3 to 5 years. This is a separate requirement from that to carry out an ICA, and guidance on this requirement is provided in GENPRU 1.2.73AG. In particular, firms should note that there is no requirement that the level of capital required as identified by the ICA should be equal to, or exceed, the CRR.

...

7.1.10  G  GENPRU 1.2.42R requires a firm to carry out stress tests and scenario analyses for each of the major sources of risk identified in accordance with GENPRU 1.2.30R. A firm may also approach the assessment of the adequacy of its capital resources choose to carry out its ICA in another way than through the use of stress tests and scenario analyses. The method should be proportionate to the size and nature of its business.

...

7.1.68  G  A Where a firm may choose to carry out the assessment of the adequacy of capital resources its ICA through the use of stress testing and scenario analyses (noting that GENPRU 1.2.42R requires stress tests and scenario analyses to be undertaken to determine the overall financial adequacy of a firm’s financial resources). Where used, such testing should reflect the potential range of outcomes for the risk being quantified, consistent with the prescribed confidence level for the ICA.