Consultation Paper | CP27/15

The prudential regime for non-Solvency II insurance firms and consequential amendments

August 2015

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Responses are requested by Monday 12 October 2015.

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1 Overview

1.1 This consultation paper (CP) sets out proposals for new Parts of the Prudential Regulation Authority (PRA) Rulebook that would apply only to insurance firms that are outside the scope of Solvency II from 1 January 2016. Collectively, these firms are referred to as non-Directive firms (NDFs).

1.2 In its approach document[1], the PRA made a commitment to recast the Handbook inherited from its predecessor, the Financial Services Authority (FSA). In addition, the PRA has adopted final rules to implement Solvency II. Therefore, the PRA is now considering the regime for firms outside the scope of Solvency II and how to carry forward requirements for these firms into the new PRA Rulebook.

1.3 This consultation aims to reshape the current rules which apply to NDFs into a coherent and simpler format. The assessment of the existing material being consulted upon has taken into account the specific population of firms that these rules will apply to but does not introduce significant changes to policy. The PRA has sought to streamline the rules where possible and has followed the drafting approach outlined in paragraphs 1.7 to 1.9 and in the PRA Rulebook consultations[2].

1.4 The scope of application of each Part reflects how the rules currently apply to NDFs. Therefore there are generally separate Parts of the Rulebook for friendly societies and other insurers. The exceptions are the Non-Solvency II Firms - Governance, Non-Solvency II Firms - Actuarial Requirements, Non-Solvency II Firms - With-Profits, Non-Solvency II - Run-Off Operations and Non-Solvency II Firms – Transitional Measures Parts which contain rules for all NDFs.

1.5 The transition from the style of the PRA Handbook to the PRA Rulebook will benefit PRA-authorised firms, who will be able to access clearer and more concise rules. In addition, clearly drafted supervisory statements and statements of policy, alongside the Rulebook, will facilitate a more comprehensive understanding of the PRA's requirements and expectations. This will assist firms to comply with PRA rules.

1.6 This consultation also proposes consequential amendments necessary to reflect the adoption of the Solvency II Firms Sector of the PRA Rulebook. These proposals are discussed in Chapter 7. Interdependencies exist between the different Sectors of the Rulebook. Consequential amendments have therefore been presented alongside the NDF rules to aid analysis of the proposed changes.

Drafting approach

1.7 The PRA has drafted the proposals taking the following approach:

- PRA Handbook rules and directions have been consolidated into a new or existing Rulebook Part, or deleted if appropriate; and

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[1] *The PRA's approach to insurance supervision*; June 2014; www.bankofengland.co.uk/publications/Documents/praapproach/insuranceappr1406.pdf.

[2] See PRA CP2/14 *'The PRA Rulebook'*, January 2014; www.bankofengland.co.uk/pra/Pages/publications/rulebookcon.aspx; PRA CP25/14 *'The PRA Rulebook: Part 2'*, November 2014; www.bankofengland.co.uk/pra/Pages/publications/cp/2014/cp2514.aspx; and PRA CP17/15 *'The PRA Rulebook: Part 3',* April 2015; www.bankofengland.co.uk/pra/Pages/publications/cp/2015/cp1715.aspx.

- PRA Handbook guidance has been consolidated into: a new or existing supervisory statement; rules if a direct requirement is more appropriate; a statement of policy if the material relates to how the PRA will act; moved to the PRA's website if process related; or deleted if appropriate.

1.8 The rules proposed in this CP do not represent a fundamental policy change; they are, in substance, replacing the equivalent rules currently in the Handbook where appropriate. The only exception are new governance rules relating to NDFs above a defined threshold as explained in 2.1 to 2.3 of this document.

1.9 The proposals retain some existing Handbook guidance in the form of a supervisory statement or if it is process guidance, moved to the PRA's website. The proposals also delete guidance which either does not set out a PRA expectation (usually because it restates legislation, or sets out an obvious procedural step), or is sufficiently covered in a new or existing supervisory statement. The deletion of existing Handbook guidance is not intended to signal a change in policy, but to ease comprehension.

1.10 Firms are expected to continue to make judgements about compliance with a rule in accordance with the PRA's published policies.

Content mapping

1.11 This table maps modules from the PRA Handbook to the corresponding Rulebook Part or supervisory statement.

Handbook Module	Rulebook Part
GENPRU 1.2, 1.3	Insurance Company – Overall Resources and Valuation
INSPRU 1.1	Insurance Company – Technical Provisions
INSPRU 1.2, 3.1	Insurance Company – Mathematical Reserves
GENPRU 2.1 INSPRU 1.1	Insurance Company – Capital Resources Requirements
GENPRU 2.2, 2 Annex 7	Insurance Company – Capital Resources
GENPRU 2 Annex 1	Insurance Company – Capital Resources Table
INSPRU 1.5	Insurance Company – Internal Contagion Risk
INSPRU 2.1	Insurance Company – Exposure Limits
INSPRU 3.1	Insurance Company – Risk Management
IPRU(FSOC) 4, Appendix 1, 2, 4, 5	Friendly Society – Overall Resources and Guarantee Fund
	Friendly Society – Required margin
	Friendly Society – Financial Prudence
	Friendly Society – Asset Valuation
	Friendly Society – Liability Valuation
SYSC 3, 13, 14, 17 IPRU(FSOC) 2.1, 2.2, 3.1 New (see Chapter 2 of this document)	Non-Solvency II Firms – Governance
INSPRU 1.1	Non-Solvency II Firms – With-Profits
Sup 4	Non-Solvency II Firms – Actuarial Requirements
Sup App 2	Non-Solvency II Firms – Run-off Operations
New	Non-Solvency II Firms – Transitional Measures
GENPRU 1.2 INSPRU 7	Supervisory Statement: Non-Solvency II insurance companies – Capital assessments

Statutory obligations

1.12 The proposals are compatible with the PRA's statutory objectives under the Financial Services and Markets Act 2000 (FSMA) to promote the safety and soundness of PRA-authorised firms[1] and in the context of insurance, to contribute to policyholder protection.[2] The proposals advance the PRA's general and insurance specific objectives by assisting firms to meet the PRA's requirements.

1.13 When discharging its general rule-making function, the PRA must, so far as is reasonably possible, facilitate effective competition in the markets for services provided by PRA-authorised persons in carrying on regulated activities.[3] The PRA has assessed whether the proposals in this CP facilitate effective competition. These proposals relate to existing rules and guidance which are being carried over to the Rulebook. The PRA considers that these proposals do not give rise to any adverse effects on competition and could facilitate effective competition by reducing unnecessary regulatory burdens. The PRA therefore considers the content of this consultation to be compatible with its secondary objective.

1.14 The PRA is required to perform an analysis of the economic impact in respect of proposed rules. The PRA considers that the proposals in this CP do not amount to a material change to its rules or policy.

1.15 In making its rules and establishing its practices and procedures, the PRA must have regard to the Regulatory Principles as set out in FSMA.[4] The PRA may not act in an unlawfully discriminatory manner. It is required, under the Equalities Act 2010, to have due regard to the need to eliminate discrimination and to promote equality of opportunity in carrying out its policies, services and functions.[5] To meet this requirement, the PRA has performed an assessment of the policy proposals and does not consider that the proposals give rise to equality and diversity implications. The PRA expects any incremental costs arising from its proposals to be only of minimal significance.

1.16 FSMA requires that the PRA assesses whether, in its opinion, the impact of the proposed rules on mutuals will be significantly different from the impact on other firms.[6] The PRA does not expect the incremental costs to differ for mutual firms compared to other firms.

1.17 This consultation closes on Monday 12 October 2015. The PRA invites feedback on the proposals set out in this consultation. Please address any comments or enquiries to CP27_15@bankofengland.co.uk.

2 Governance

2.1 This chapter sets out the PRA's proposals to replace the rules in Chapters 3, 13, 14 and 17 of SYSC and 2.1, 2.2 and 3.1 of IPRU(FSOC) with a new Rulebook Part 'Non-Solvency II Firms - Governance'. It also sets out new specific governance rules for NDFs with assets over £25 million in respect of regulated activities. The intention behind and rationale for the PRA's

1 See s.2B(1) and s.2B(2) FSMA.
2 See s.2C FSMA
3 See s.2H FSMA.
4 See s.2H and s.3B FSMA.
5 Equalities Act 2010, section 149(1).
6 Section 138K of FSMA.

decision to apply an enhanced set of governance requirements to NDFs above this threshold was signalled in CP12/15[1].

2.2 The regime and the rest of the draft governance rules specifically for these NDFs are set out in CP26/15[2].

2.3 Draft rules regarding specific governance functions of internal control, internal audit and the actuarial function included in this CP are new for NDFs over the aforementioned threshold. These are based on similar Solvency II requirements but represent an abridged version to take into account the fact that these firms are not required to follow Solvency II rules, for example references to other parts of the Solvency II regime, such as the Own Risk and Solvency Assessment, have been removed. These functions will be particularly relevant for the larger firms in the population especially as they may subsequently transition to Solvency II. Therefore they would help ensure that such firms implement an enhanced governance structure that would facilitate any such transition.

2.4 Current SYSC sourcebooks are comprised mainly of guidance. Chapters 1, 2, 11, 15 and 16 of SYSC have been deleted and have not been moved directly into new draft rules or replaced by supervisory statements. However the principles captured within these sections are carried through into a clearer and streamlined set of reformulated draft rules set out in the draft Part 'Non-Solvency II Firms – Governance'. The draft rules in the new governance section when taken alongside the PRA Fundamental Rules achieve a comparable outcome. Expectations on firms with regards to governance requirements have not changed.

2.5 Guidance on outsourcing has been recast into high level draft rules. This is not intended to signal a change in the PRA's approach to firms having outsourcing arrangements as the rules reflect the expectations outlined in the current guidance. The reason these are now rules rather than supervisory expectations is because proper management of outsourcing arrangements should be considered as a requirement in the same way as management of internal govenance arrangements. This also mirrors the approach taken for credit unions in CP22/15[3] where there is a similar rule on outsourcing.

3 Non-Solvency II firms other than friendly societies

3.1 The draft rules for NDFs other than friendly societies do not include changes in the substance of policy but do remove rules and guidance in line with the drafting approach outlined in paragraph 1.7.

Capital resources requirements, valuation, technical provisions and risk management

3.2 Draft rules relating to capital resources and requirements from GENPRU 1 and 2 and INSPRU 1, 2 and 3 are split into nine smaller Parts in line with the structure of the PRA Rulebook.

3.3 The draft rules propose to amend the abbreviation CRR meaning Capital Resources Requirements to CR Requirements to avoid the use of CRR which is more commonly associated with the European banking Capital Requirements Regulation.

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1 PRA CP12/15 *'Senior Insurance Managers Regime: a streamlined approach for non-Solvency II firms'*, March 2015; http://www.bankofengland.co.uk/pra/Pages/publications/cp/2015/cp1215.aspx

2 PRA CP26/15 *'The Senior Insurance Managers Regime: implementation proposals for non-Solvency II firms'*, August 2015; http://www.bankofengland.co.uk/pra/Pages/publications/cp/2015/cp2615.aspx

3 PRA CP22/15 *'Reform of the legacy Credit Unions* sourcebook', June 2015; http://www.bankofengland.co.uk/pra/Pages/publications/cp/2015/cp2215.aspx

3.4 The PRA proposes to maintain the current prudential requirements. The draft rules allow firms to continue to calculate capital requirements as they currently do. However, as Solvency I will fall away, the PRA no longer needs to maintain the full complexity of the rules that originated from Solvency I Directive requirements. Therefore these draft rules propose the removal of parts of those requirements, for example the guarantee fund rules. This should not create a burden on firms but simplify their calculations.

3.5 Base capital resources requirements will remain at the current levels but converted from Euros to Sterling at an appropriate exchange rate calculated when the final rules are made. For the purposes of this consultation a rate of 1.24 has been used which is an average of indicative rates from January 2013 to July 2015 and figures have been rounded to the nearest £100,000. We propose to continue our current practice whereby the amounts may be increased from time to time, following consultation, to reflect underlying rates of inflation.

3.6 Obsolete capital requirement calculations, ie those that will no longer apply to any firms in the expected NDF population on 1 January 2016, will be deleted. For example the removal of base capital resources requirement figure for captive reinsurers.

3.7 The PRA proposes to delete the Enhanced Capital Requirement rules and guidance as it only applies to a very small sub-set of NDFs. The maintenance of this requirement within the NDF population is not deemed justifiable given the intention to simplify and rationalise current rules.

3.8 The PRA proposes to reformulate the guidance and rules relating to Individual Capital Assessments, capital planning and stress testing and scenario analysis into a supervisory statement. This will reduce the current burden on firms in recognition of the nature, scale and complexity of the firms to which these provisions will apply. The draft supervisory statement at Appendix 4 follows the same principles but seeks to restate PRA expectations in a proportionate way.

3.9 FSA CP12/13[1] consulted on the deletion of specific group capital requirements. The PRA proposes to carry through this deletion in this CP.

4 Non-Solvency II firms that are friendly societies

4.1 The draft rules for NDFs that are friendly societies do not change the substance of the current policy. However there is substantive change in their structure. Draft rules deriving from IPRU(FSOC) will be split into five parts.

4.2 The draft rules will allow firms to continue to calculate their capital requirements as currently. The PRA proposes to maintain its current expectation of friendly societies in terms of overall resources and guarantee fund, required margin, financial prudence and asset and liability valuation under the restructured rules.

4.3 The minimum guarantee funds will remain at current levels but will be converted from Euros to Sterling at an appropriate exchange rate calculated when the final rules are made. For the purposes of this consultation a rate of 1.24 has been used which is an average of indicative rates from January 2013 to July 2015 and figures have been rounded to the nearest £100,000.

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[1] FSA CP12/13 *'Transposition of Solvency II – Part 2'*, July 2012; www.bankofengland.co.uk/pra/Pages/publications/transpositionofsolvency2.aspx.

We propose to continue our current practice whereby these amounts may be increased from time to time, following consultation, to reflect underlying rates of inflation.

4.4 The PRA does not propose to change the current approach to Partnership Pension Friendly Societies. Currently, only a streamlined set of rules apply to them, this will remain unchanged.

5 With-profits

5.1 The substantive provisions relating to with-profits have been consulted on and the final rules published in PS2/15[1].

5.2 The PRA is proposing to split with-profits rules into two Parts, applicable to Solvency II firms and NDFs respectively. This allows the with-profits Parts to align correctly with the specific asset rules applicable to each type of firm.

6 Transitionals

6.1 The PRA proposes to include an appropriate measure that will apply to certain firms in run-off that may benefit from Solvency II transitional measures (See Appendix 3). This PRA measure will apply relevant NDF rules to these firms to take into account the fact they will be exempt from the requirement to operate in accordance with Titles I, II and III of the Solvency II Directive.

6.2 The PRA does not propose to include a rule transitioning existing waivers across automatically. The PRA believes that existing waivers are related, on the whole, to reporting and no amendments for reporting are included in this CP, see Chapter 8. If firms wish to maintain the benefit of waivers they may have related to other existing rules they will need to identify the equivalent new rule and submit a waiver application in time for 1 January 2016.

7 Consequential amendments

7.1 In PS2/15, the PRA published its final rules to implement the Solvency II Directive which will apply from 1 January 2016. In light of the final rules adopted by the PRA, further amendments need to be made to the PRA Rulebook. The objective of such consequential amendments is not to signal a change in substantive policy, but to ensure that the PRA Rulebook maintains its consistency and appropriate simplicity.

7.2 The proposed rule changes associated with consequential amendments can be found in Appendix 3. The proposed changes are primarily concerned with changes to the glossary and drafting corrections. In addition, the PRA is proposing that Information Gathering 2.1 and 3.2 be dis-applied to Solvency II firms, the Society of Lloyd's and managing agents. This is because Solvency II contains its own outsourcing provisions which have been transposed through Solvency II Firms - Outsourcing 7.4(1) and (3).

7.3 The PRA is also proposing that 2.13 of the Solvency II reporting instrument will be amended so that Solvency II friendly societies are not required to submit National Specific Templates in electronic format but can do so if they choose. The Friendly Societies Act 1992 prevents the PRA from requiring friendly societies to submit returns electronically.

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[1] PRA CP2/15 *'Solvency II: A new regime for insurers'*, March 2015; http://www.bankofengland.co.uk/pra/Pages/publications/ps/2015/ps215.aspx

8 Reporting

8.1 This CP does not include any proposals for amendments to the reporting regime. Firms will be required to comply with Chapter 9 of IPRU(INS) or Chapter 5 of IPRU(FSOC) for all regulatory reports with reference dates on or before 31 December 2015. Consequential amendments to the reporting rules for NDFs, following the rule changes proposed in this CP, and any other changes to make reporting rules clearer and more concise will be consulted on by end 2016 Q1. The intention is that amended reporting rules for NDFs would apply from financial years ending during 2016.

Appendices

1 PRA Rulebook: Non-Solvency II Firms: Non- Solvency II Firms Regime Instrument 2015 available at www.bankofengland.co.uk/pra/Pages/publications/cp/2015/cp2715.aspx

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2 Handbook (Rulebook Consequentials) Instrument 2015 available at www.bankofengland.co.uk/pra/Pages/publications/cp/2015/cp2715.aspx

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3 PRA Rulebook: Glossary and Insurance Consequentials Instrument 2015 available at www.bankofengland.co.uk/pra/Pages/publications/cp/2015/cp2715.aspx

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4 Draft Supervisory Statement: Non-Solvency II insurance companies – Capital assessments

Appendix 4: Draft Supervisory Statement: Non-Solvency II insurance companies – Capital assessments

1 Overview

1.1 This draft supervisory statement (SS) is addressed to non-Solvency II insurance firms that are not friendly societies. For the purposes of this statement, these firms are described collectively as non-Directive insurance companies.

1.2 This draft statement should be read alongside relevant statutory legislation, as well as the Insurance Company – Overall Resources and Valuation Part of the Prudential Regulation Authority (PRA) Rulebook.

1.3 This draft statement expands on the PRA's general approach as set out in the PRA's approach to insurance supervision.[1] By clearly and consistently explaining its expectations of firms in relation to the particular areas addressed, the PRA seeks to advance its statutory objectives of ensuring the safety and soundness of the firms it regulates, and contributing to securing an appropriate degree of protection for policyholders. The PRA has considered matters to which it is required to have regard, and it considers that this statement is compatible with the Regulatory Principles and relevant provisions of the Legislative and Regulatory Reform Act 2006.

2 Overall resources

2.1 Non-Directive companies must maintain adequate overall financial resources in accordance with Insurance Company - Overall Resources and Valuation 2.3 of the PRA Rulebook.

2.2 This draft supervisory statement is not intended to signal a change in expectations regarding a firm's ability to at all times meet this rule. The PRA therefore would not expect this proposed supervisory statement to change a firm's assessment of its current capital levels.

2.3 The PRA does not intend to assess regularly and set Individual Capital Guidance for non-Directive companies. Rather Insurance Company – Overall Resources and Valuation 2 requires a firm to identify and assess risks to its being able to meet its liabilities as they fall due, to assess how it intends to deal with those risks and to quantify the financial resources it considers necessary to mitigate those risks. This is referred to as a capital assessment, which should be carried out in accordance with Insurance Company – Overall Resources and Valuation 2.

2.4 The method a firm chooses to carry out such a capital assessment should be proportionate to the size and nature of its business. The PRA expects a firm to be able to carry out these assessments for a time horizon of 3 to 5 years.

3 Purpose

3.1 A capital assessment should reflect both a firm's business model and its commercial objectives and give the required level of confidence that a firm's liabilities to policyholders will

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[1] *PRA's approach to insurance supervision*; June 2014; www.bankofengland.co.uk/publications/Documents/praapproach/insuranceappr1406.pdf.

be paid. A firm should consider and be able to provide an explanation for all material risks which may arise before the policyholder liabilities are settled based on a reasonable assumption of the expected likelihood of these risks crystallising.

3.2 A capital assessment should demonstrate that a firm holds sufficient capital to be able to make any planned investments and take on new business (if it wishes to do so). It should also ensure that if a firm had to close to new business (if it has not already done so), it would be able to meet its existing commitments. Where possible, the reasonableness of the results should be supported by considering complementary evidence of the financial resources needed.

4 Methodology

4.1 The methodology used within the capital assessment should allow a firm to quantify the financial effect of risks. It should also reflect the nature of a firm's business and be consistent with the way in which a firm identifies and manages risk.

4.2 A firm’s capital assessment should:

- reflect the firm's assets, liabilities, and future business plans;
- be consistent with the firm's management practice, systems and controls;
- consider all material risks that may have an impact on the firm's ability to meet its liabilities to policyholders; and
- use a valuation basis that is consistent throughout the assessment.

4.3 The results of the capital assessment should be supplemented by analysis of the sources of the risks to which the firm is exposed, discussion of the events which are most likely to threaten the safety and soundness of the firm and the potential mitigating actions which the firm may take to manage them.

5 Representative of firms’ characteristics

5.1 A firm should consider the impact of potential new business on capital required and available capital in their capital assessment. Any contract that a firm is legally obliged to renew should be considered part of a firm's existing liabilities and not treated as new business.

5.2 Where a firm has not already closed to new business, the capital assessment should be made on the basis that a firm closes to new business after an appropriate period.

5.3 Where the capital assessment assumes that a firm may move capital from one part of its business to another across legal or geographical boundaries, the firm should explain how it would satisfy itself that it could achieve the necessary capital movements in times of distress and why such items are free from restriction on their transferability. The firm should also consider any associated costs or restrictions in the amount of capital that would be able to be transferred.

6 General assumptions

6.1 A firm's management should determine their own risk appetite or confidence level and a risk measure that they believe is suitable for the management of the business. Firms should however consider Chapter 8 of this SS.

6.2 A firm should be able to explain its rationale for choosing its approach to risk and assessment of capital.

6.3 A firm should be able to evidence the reasoning and judgements underlying its assessment and, in particular, justify:

- the assumptions used;
- the appropriateness of the methodology used; and
- the results of the assessment.

6.4 A firm should also be able to identify the major differences between the assessment at a confidence level of 99.5% over one year and any other assessments carried out using a different confidence level.

6.5 Key parameters and assumptions should be regularly reviewed. A firm should consider the relevance of the data and the nature and value of any expert judgement used to support the choice of these assumptions especially where these data and judgement determine the most financially significant assumptions and provide justification for the calibration of these assumptions.

6.6 Where relevant, a firm should consider all risks in aggregate if intending to make appropriate allowance for diversification when completing its capital assessment. A firm should be able to describe and explain any diversification benefits allowed for.

6.7 Where there is a concentration of business from a single source (for example, a single sales channel or cedant), consideration should be given to the greater impact of a risk crystallising, compared to that for a well-diversified portfolio.

7 Material risks

7.1 A capital assessment should consider risks to the number of claims, the amount paid and the timing of a firm’s liabilities which could result in a change in the cost of those liabilities.

7.2 The assets that a firm holds carry risk, both in their own right and to the extent that they do not match the liabilities that they are backing. The risk associated with these assets should be considered over the full term for which the firm expects to carry the liabilities.

8 Valuation basis

8.1 The valuation of the assets and of the liabilities should reflect their economic substance. A realistic valuation basis should be used for assets and liabilities taking into account the actual amounts and timings of cash flows under any projections used in the assessment.

8.2 In carrying out a capital assessment, wherever possible the value of assets should be marked to market. Where marking to market is not possible, the capital assessment should use a method suitable for assessing the underlying economic benefit of holding each asset.

8.3 The methods and assumptions used in valuing the liabilities should contain no explicit margins for risk, nor should the approach be optimistic. The valuation of liabilities should be consistent with the valuation of assets. To the extent the market price includes an implicit allowance for risk, this should be included within the valuation.

8.4 The methodology used to place a value on an asset or a liability following a risk event should be consistent with the methodology used prior to the risk event.

8.5 Approximate valuation methods may be used by the firm for minor lines of business or to capture less material types of risk. However, the firm should avoid methods which underestimate the risk in aggregate.

8.6 The firm should carry out a broad reconciliation of key parts of any balance sheet used in the capital assessment with the corresponding entry from audited results where possible.

9 Documentation

9.1 In accordance with Insurance Company – Overall Resources and Valuation 2.10 these assessments should be documented so that they can be easily reviewed by the PRA if the PRA chooses to undertake an assessment of the adequacy of the firm's capital resources.

9.2 Where the PRA requests a firm to submit to it a written record of the firm's assessment of the adequacy of its capital resources, the PRA expects firms to be able to make an assessment on its request comparable to a 99.5% confidence level over a one year timeframe that the value of assets exceeds the value of liabilities. Firms may choose to base any regular assessment on an alternative confidence level.

10 Stress testing and scenario analysis

10.1 A stress test is for the purposes of evaluating the impact of different adverse scenarios on the capital position of a firm. For example, simultaneous movements in a number of risk categories affecting all of a firm’s business operations, such as business volumes, investment values and interest rate movements.

10.2 Depending on the nature, scale and complexity of a firm’s business, carrying out stress tests and scenario analyses can be an appropriate way for a firm to estimate the financial resources it would need to continue to meet Insurance Company - Overall Resources and Valuation 2.3. Such testing should reflect the potential range of outcomes for the risks being quantified and should take into account an appropriate range of adverse circumstances and events relevant to the firm's business and risk profile. For example, circumstances and events occurring over a protracted period of time or sudden and severe events, such as market shocks or other similar events or a combination of the two.

10.3 The nature, depth and detail of the analysis will depend, in part, upon the firm’s capital strength and the robustness of its risk prevention and risk mitigation measures.

10.4 Stress testing and scenario analyses can be used to carry out the capital assessment and, if so, should be documented in line with Insurance Company – Overall Resources and Valuation 2.10.

10.5 The overall assessment of capital may require the aggregation of results from the stress and scenario testing. The firm should be able to explain its choice of aggregation approach and its understanding of the implications of combining the individual risks. The firm should be satisfied that the resultant capital provides the appropriate degree of confidence, given the variability of the underlying risks and the uncertainty associated with those risks. A useful component of this process is the characterisation and explanation of a range of possible circumstances that could give rise to a loss of this magnitude.

10.6 If carrying out stress tests and scenario analyses, firms should estimate the financial resources that it would need in order to continue to meet Insurance Company – Overall Resources and Valuation 2.3 and the CR Requirement (Insurance Company – Capital Resources Requirements 3.1) in the adverse circumstances being considered. It should only include financial resources that could be reasonably relied upon in those circumstances and take account of any legal or other restriction on the use of financial resources.

10.7 A firm should 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.

10.8 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. The firm should also consider undertaking reverse stress testing.

11 Management actions

11.1 Where the benefit of prospective management actions are incorporated in a firm's capital assessment, firms should understand the financial effect and any preconditions that might affect the value of management actions as risk mitigants. In addition, firms should be able to justify the choice and realism of prospective management actions and the assumptions used. A firm should be able to show the financial impact of a management action.

11.2 A firm should be able to identify any realistic management actions intended to maintain or restore its capital adequacy in a stress scenario and estimate the effects of the stress scenario with and without such management actions.

11.3 A firm may consider scenarios in which expected future profits will provide capital reserves against future risks. However, it would only be appropriate to take into account profits that can be foreseen with a reasonable degree of certainty as arising before the risk against which they are being held could possibly arise.

11.4 Where pension obligation risk is considered, a firm should assess any 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.

11.5 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.