

# Guidance Note 4 (2002)



*Date of coming into effect: 28 June 2002*  
*Amended: 15 May 2003*

## Resilience test for insurers

### Application

- 1.1 This Guidance Note is relevant to *insurers* (including *friendly societies*).

### Introduction

- 2.1 Rule 5.17 of the Interim Prudential Sourcebook for Insurers (*IPRU(INS)*) requires an *insurer* to make prudent provision against the effects of possible future changes in the value of assets on the adequacy of these assets to meet liabilities. Paragraph 16 of Appendix 5 to the Interim Prudential Sourcebook for Friendly Societies (*IPRU(FSOC)*) contains a similar rule for *friendly societies*.
- 2.2 Guidance on how *insurers* should interpret these rules came into force on 1 June 2002 and is contained in Guidance Note 5.1 in *IPRU(INS)* and (for *friendly societies*) in paragraph 12 of Annex 4 to *IPRU(FSOC)*.
- 2.3 Recent events in the markets have shown some problems with the tapering formula used in part of the test. The *FSA* is therefore retaining the current test but including an alternative tapering formula that should be more responsive to difficult market conditions. Further work on appropriate tests is in any case in train in respect of the move in 2004 to the integrated Prudential sourcebook, which will be consulted on later this year.
- 2.4 Guidance Note 5.1 in *IPRU(INS)*, and paragraph 12 of Annex 4 to *IPRU(FSOC)* are suspended and replaced with the guidance below, for the temporary period that this guidance note remains in effect.

### Revised guidance on resilience test

- 3.1 The resilience test is a requirement for 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 liabilities. This requirement is in rule 5.17 of *IPRU(INS)* and (for *friendly societies*) in paragraph 16 of Appendix 5 to *IPRU(FSOC)*.
- 3.2 *Firms* should, as a minimum, consider the scenario of a fall in the *market value* of equities of at least 10% or, if greater, the lower of:
- (1) 25%, or such lower amount which 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 rule 5.11(9) of *IPRU(INS)* and paragraph 10(9) of Appendix 5 to *IPRU(FSOC)*); and
  - (2) 25% less any percentage reduction between the current FTSE Actuaries All Share Index and its average over the last 90 calendar days.
- 3.3 In 3.2(1), *firms* should make the assumption that the earnings yield on equities will 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.

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- 3.4 In 3.2(2), the current index should be compared to its recent average, based on levels at the close of business. Of the last 90 calendar days, only those on which the London Stock Exchange was open for trading should be taken into account in determining the average. Where there has been a fall, such a percentage fall should be deducted from the 25% in arriving at this part of the resilience test. The *appointed actuary*, in advising the *firm*, would be expected to apply his or her own professional judgement in considering the level of the market and the prudence of the result of this part of the resilience test.
- 3.5 The *appointed actuary*, in advising the *firm*, would then be expected to apply his or her own professional judgement in considering the level of changes in the *market value* of, and yield on, other types of investment held by the *firm* for the purpose of this resilience test. The prudence concept should be paramount. Reductions in fixed interest yields, or changes in the shape of the yield curve, are among the obvious possibilities.
- 3.6 The *firm* should also take account of the nature of the assets and liabilities. For example, a *firm* which has only unit linked business, some of which carries a guaranteed annuity rate, should not necessarily assume that equity values fall in applying tests for lower fixed interest rates. Indeed *firms* should consider their resilience to a rise in equity values combined with falling interest rates.
- 3.7 The FSA also expects that *firms* will continue to investigate a wide range of possible future investment scenarios for the purpose of their own stress testing and risk management.

## Commencement and duration

- 4.1 This guidance note:
- (1) is made on 28 June 2002; and
  - (2) comes into effect on 28 June 2002.
- 4.2 Unless we alter or revoke it earlier, this guidance note will have effect until the Integrated Prudential Sourcebook comes into force. Until then this guidance note has the same status, and you may rely on it, in the same way as other guidance given by the *FSA*. This is explained in the Reader's Guide to the *FSA*'s Handbook of rules and guidance, paragraphs 28 to 30.

## General

- 5.1 This guidance note should be interpreted in accordance with the definitions in *IPRU(INS)* or (for *friendly societies*) in *IPRU(FSOC)*.
- 5.2 We give this guidance under section 157 of the Financial Services and Markets Act 2000. As it is given for a limited time only, it is not intended to have continuing effect within the meaning of section 158 of that Act. This guidance is given without consultation because we believe that failure to continue with the amended guidance would be prejudicial to the interests of policy holders and potential policy holders.