

Response to feedback received

Stress Testing

Introduction

The Bank has finalised the issuance of the policy document on Stress Testing for insurers and takaful operators (including professional reinsurers and retakaful operators).

During the consultation period, the Bank received written submissions from a range of respondents, including insurers and takaful operators, industry associations and other regulatory authorities. A series of engagement sessions were also conducted to allow for more focused and in-depth discussions on the proposed requirements.

The Bank is grateful for the feedback and suggestions received during the consultation process. Key comments received and the Bank's responses are provided in the following sections. Other comments and suggestions for clarification have been incorporated in the final policy document where appropriate.

1. Inter-linkages between Stress Testing and other requirements

Some respondents requested for clarity on the inter-linkages between requirements related to the conduct of stress test and those contained in other policy documents.

- 1.1 Stress testing is an important element of the licensed person's risk management and decision making process. This policy document provides standards and guidance around the technical requirements related to the conduct of stress testing. The standards and guidance for specific applications of stress testing are provided in the relevant policy documents issued by the Bank, as listed in paragraph 1.2 and must be read together with this policy document.
- 1.2 The Bank's requirements on the applications of stress testing may be found in the following policy documents :
- a) Policy document on Risk Governance (RG)¹ on the application of stress testing within risk management frameworks;
 - b) Policy document Financial Condition Report (FCR)² on the use of multi-period stress testing by the Appointed Actuary (AA) in assessing the adequacy of the licensed person's capital; and
 - c) Policy document on Internal Capital Adequacy Assessment Process (ICAAP) for Insurers³ and policy document on Internal Capital Adequacy Assessment Process (ICAAP) for Takaful Operators⁴ on the application of stress tests for setting the individual target capital level (ITCL) and developing a capital management plan.

Please refer to Appendix 1 for a graphical illustration of the inter-linkages between these policy documents.

- 1.3 Licensed persons' risk management frameworks should be responsive to internal and external changes and support its ability to anticipate emerging risks. In this regard, the policy document on Risk Governance requires a licensed person to perform stress tests which capture material sources of risk under plausible adverse scenarios as part of the risk management process and integrate the results of the stress tests into its decision making.
- 1.4 The FCR is intended as a report that provides independent advice from the AA to the board on material risks and threats to the financial condition of the licensed person, which includes an opinion on capital adequacy. The board may leverage on this advice in fulfilling its oversight role over an insurer's or takaful operator's ICAAP. The AA will form an opinion on capital adequacy based on the results of a multi-period stress test, which replaces the requirement to conduct Dynamic Solvency Testing.

¹ BNM/RH/GL/013-5 "Risk Governance"

² BNM/RH/GL/003-17 "Financial Condition Report"

³ BNM/RH/GL/003-29 "Guidelines on Internal Capital Adequacy Assessment Process (ICAAP) for Insurers"

⁴ BNM/RH/GL/033-2 "Internal Capital Adequacy Assessment Process for Takaful Operators"

- 1.5 For the purpose of capital management, stress testing is used to derive the internal target capital level (ITCL) and to develop the licensed person's capital management plan (CMP). The process of stress testing is useful in assessing overall capital adequacy and evaluating the appropriateness of capital thresholds and corrective actions for maintaining adequate capital levels.
- 1.6 A licensed person may use the results of stress tests to meet the requirements of these different policy documents, as well as for other internal objectives of the licensed person, provided that appropriate adjustments and modifications are made to meet the purposes to which the results are applied.

2. Specified Scenarios by the Bank

Some respondents requested for more clarity on the way in which stress testing using specified scenarios would be conducted.

- 2.1 The specified scenarios are issued by the Bank to a licensed person and may be updated from time to time to reflect changes to the operating environment. The submission period and any other additional reporting requirements will also be specified. These will reflect the complexity and purposes of the exercise. A longer period will be allowed if extensive modelling or more detailed reporting is required. Conversely, a shorter period may be imposed where the Bank requires immediate input into its financial surveillance processes.
- 2.2 A number of respondents enquired if the results of prescribed stress testing would be made available to all insurers and takaful operators. The Bank considers such information to be useful for improving the quality of stress testing and risk and capital management of licensed persons, although appropriate allowance must be made for differing risk profiles across the industry. The Bank therefore aims to communicate these results in an aggregated form when a suitable level of quality and consistency in stress testing practices has been established.

3. Detailed requirements on conduct of stress testing

Some respondents requested for the Bank to consider a reference date that is more in line with the licensed person's business planning cycle.

- 3.1 The policy document does not specify the reference date of stress testing. Instead, licensed persons will set the reference date based on the objective of the stress test. For example, when conducting a multi-period stress test for the FCR, the reference date will be the quarter preceding the date of the FCR⁵ while stress testing for the determination of ITCL will depend on the licensed person's ICAAP annual cycle⁶.

⁵ Paragraph 17.2 of the policy document FCR

⁶ Paragraph 11.2 of the policy document ICAAP

Some respondents enquired if Appendix 1 on the major risk categories are exhaustive.

- 3.2 Appendix 1 of the policy document provides guidance on the major risk categories with examples of risk factors for each category and may not be reflective of the risk profile or specific circumstances of each licensed person. Licensed persons should consider other risks factors that are material to their business while risk factors that are deemed not material to the specific licensed person may be excluded from the stress testing.

Some respondents requested for more guidance on the scope of Shariah Non-Compliance risk.

- 3.3 The assessment of the Shariah Non-Compliance (SNC) risk⁷ should be similar to other risks that need to be taken into consideration when establishing the stress scenarios. Details and examples of SNC are stated under the Appendix VIII of Operational Risk Reporting Requirement - Operational Risk Integrated Online Network (ORION) policy document⁸ published by the Bank in September 2014.

Some respondents requested for more clarity on the Bank's expectation with regard to reverse stress testing.

- 3.4 Reverse stress testing has been included in the policy document as guidance on an approach of stress testing. Although it is currently not a requirement to perform reverse stress testing, it can be an insightful exercise to inform the Board and management on scenarios that could give rise to adverse outcomes that are most detrimental to the objectives and continuity of the business.

Some respondents requested for the correlation matrices between risk factors to be published by the Bank.

- 3.5 The correlation between risk factors is unique for each licensed person depending on its risk profile and business mix. The inter-dependencies between risks may also vary from time-to-time with changing business and economic conditions. Hence, it is important for licensed persons to determine the correlation between risk factors according to their unique risk profile and business mix. Where there are gaps in internal data, this may need to be supplemented by published benchmarks with necessary adjustments to suit the licensed person's risk profile and business mix.

⁷ The term "Shariah Non-Compliance (SNC) risk" has been defined under Principle 1 of the Shariah Governance Framework (SGF) issued in 2009.

⁸ BNM/RH/GL 028-11 "Operational Risk Reporting Requirement - Operational Risk Integrated Online Network (ORION)"

4. Reinsurance/Retakaful and branches

Some respondents sought clarity on the scope of the stress testing requirements for branches of foreign professional reinsurers and retakaful operators.

- 4.1 The stress testing should take into account all sources of potential risks to the branch in Malaysia, which includes businesses written overseas by the branch.
- 4.2 The requirement for the Board to deliberate on the stress testing results may be fulfilled by a suitable governing authority for branches of foreign professional reinsurers/retakaful operators.

Appendix 1

Graphical illustration on the inter-linkages between Stress Testing and other policy documents

