Stress tests for insurers to be on multi-year basis

BY **JOYCE GOH**

Insurers in Malaysia will have to perform stress tests based on multi-year scenarios starting from Sept 1. This change comes amid increased downside risks to global growth.

According to a Bank Negara Malaysia policy document dated June 30, insurers will be required to choose a projection period for multi-year stress tests that is "sufficiently long to reflect the time period required to capture the full impact of a stress scenario".

Examples of stress scenarios cited by Bank Negara are the deterioration of mortality experience, a trend that may take at least two to three years to be recognised, and a period of prolonged low interest rates, where the impact on the profitability of the business may emerge over or after a few years.

"The projection period for life insurers and family takaful operators may typically be between five and six years while that for general insurers and general takaful operators may be between three and four years," Bank Negara states in the policy document sighted by *The Edge*.

The document also says that the choice of model should reflect the complexity of the relationship between risks and their impact on the licensed person's financial condition.

Industry players say the latest change is to ensure local insurers are prepared and adequately capitalised for any unforeseen circumstances that may arise over a multi-year period as well as to help assess the resilience of the companies in the event of adverse market developments.

Angie Wong, partner at PwC Malaysia, says examples of stress scenarios include changes in interest rates, inflation and equity values, increases in unemployment and deteriorating buying patterns.

"While the policy document on stress testing on a multi-year basis is new, the regulator had hinted in the 2012 ICAAP (Internal Capital Adequacy Assessment Process) framework that it would like insurers to project stress-testing scenarios over a longer period when assessing their ITCL (individual target capital levels). Performing a multi-year stress test is more realistic, considering that insurance risks are usually long term or volatile. This latest development spells the need for multi-year scenarios and provides clarity to insurers on how they should undertake stress tests," she tells *The Edge*.

Wong: A multi-year stress test is more realistic, considering that insurance risks are usually long term or volatile

Rudie: This latest change is in line with global best practice

"The policy document also states that insurers should consider the impact of risk factors or events on the financial condition of the insurance companies when they do the stress tests. Financial condition in this case can encompass quite a few things. For example, from a capital management perspective to the profitability of the company and its ability to survive future risk scenarios following plausible adverse operation scenarios over a multi-year period. This promotes self-regulation and ensures insurers have a more robust stress-testing platform as well as an effective risk management tool."

Rudie Erman Bahari, head of risk management at Etiqa Insurance and Takaful, says a strict stress test for insurers will help them address their financial vulnerabilities in the current volatile environment.

"Looking at the present economic condition and how the insurance business has evolved, the operating environment has become very volatile today. It is reasonable for companies to assess their position for more than a year. It is good for the industry. Moving forward, the stress tests need to be more detailed and robust," he adds.

"The recent change is also in line with global best practice. More developed economies such as Europe have started introducing stress tests based on multi-year periods. The change here — to project multi-year scenarios rather than one year — looks at the medium term rather

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than the short term. It is more realistic and ensures the board and management of the insurers understand the capital and solvency position of the group in a multi-year period. It ensures that we have a more robust process in terms of business and strategic projections."

With the change, insurers need only perform stress tests on an annual basis rather than twice a year. "Before this, we had to conduct stress tests on a half-yearly basis based on our financial year-end. Now, with the stress tests projected over a multi-year period, insurers only need to conduct stress tests once a year," says Rudie.

Wong opines that stress tests are an effective tool to judge if and when to reconfigure the asset portfolio, alter products and prices, and the cost and manner of reconfiguring staffing models following a multi-year stress event.

"Stress tests provide a ready platform to prepare for risk crises. Insurers can use the tool to test different responses and select the one that yields the most effective resolution. They then can put in place a contingency plan and pre-event corrections appropriate to the event," she says.

The challenge now, Wong adds, is to ensure that the stress tests are effectively used and embedded in the organisation's risk and capital management framework.

"Insurers have to ensure the scenarios they develop are robust enough. We need to move away from developing stress scenarios that are overly negative and unrealistic. Instead, we should move towards plausible adverse scenarios." E