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Member

TO: ALL LIFE INSURERS

STRESS TESTING EXERCISE FINDINGS AND FEEDBACK

APRA considers stress testing to be an integral part of risk management. It helps improve the readiness of insurers to withstand adversity by enhancing capital management, informing recovery planning and reducing the likelihood of failure and resolution.

In 2018, APRA conducted a stress testing exercise on life insurers. This involved an assessment of the internal stress testing capabilities of nine participating insurers as part of their internal capital adequacy assessment process (ICAAP). The focus areas were:

- uses of stress testing results;
- stress test design and development; and
- governance.

This letter sets out APRA's findings and feedback on each focus area for insurers to consider for improving their stress testing capabilities.

Use of stress testing results

- Whilst stress testing is a requirement of the ICAAP as per LPS 110, APRA expects insurers to use their stress testing results as an integrated part of regular capital, risk management and business strategy decision-making.

All participating insurers used their stress testing results to inform them of the adequacy of their capital buffers at a minimum. APRA recommends insurers:

- explore greater use of their stress testing results in a broader risk management and business strategy context; and
- increasingly embed stress test results in regular decision-making processes, which may include, but are not limited to: feedback loops to validate risk appetite; evaluating reinsurance adequacy; and assessing credibility of potential mitigating actions.

Stress test design and development

APRA expects insurers to design a range of severe but plausible stresses with sophisticated stress parameters. There should also be careful consideration of how and when the insurer's best estimate liability valuation assumptions will realistically alter as a consequence of the observed experience. Insurers are expected to tailor their stresses to cover the key risks they face, including current and emerging risks. The stresses should be designed with a clear objective in mind, or hypothesis to investigate, which provides a clear link to the implications of the results.

Most participating insurers demonstrated reasonable levels of sophistication in their stress test design, covering scenarios, sensitivities and reverse stresses. There was also a wide range of severe but plausible stresses, which challenged the capital position and balance sheet of the insurer. These stresses largely covered a range of risks that are well known to life insurance business. APRA recommends insurers:

- incorporate emerging risk scenarios into the stress testing program, which may potentially include, for example, cyber-attacks, competitor disruptions and integration risk scenarios from acquisitions, to gain additional insights into their risk profile;
- design stresses with objectives that consider their business strategy and the current economic environment, so that the generated results are highly relevant and meaningful; and



- carefully consider the impact of deviating from their usual best estimate valuation assumption practices in stress scenarios, particularly on the realism of the stress impact and the plausibility of consequential repricing actions.

Governance

APRA expects insurers to have a well-structured stress testing framework embedded within the organisation. This should include wide organisational engagement throughout the stress testing process, structured roles and responsibilities applied in practice and continuous improvements being made to stress testing capabilities.

APRA also expects that the board reviews and challenges the design and results of stress tests, as well as their implications for the insurer. The board should also be involved in endorsing the appropriate mitigating actions selected in response to a stress. Mitigating actions should be linked to the recovery plan as much as possible.

Most participating insurers had a sound stress testing framework with formalised structures and engagement across multiple areas of the organisation. APRA recommends insurers:

- capture and document the key discussion points related to the board's review of, and challenge to, the stress test results to ensure there is transparency; and
- select the appropriate mitigating actions by assessing the feasibility (whether the action could be implemented) and the effectiveness (quantifying the impact) of a range of available responses for different stresses.

Actions and next steps

APRA expects all insurers to self-assess their own internal stress testing framework in light of the findings above and consider ways they could improve their capabilities. The results of this self-assessment and actions to improve capabilities should be documented in subsequent ICAAP reports. If you have any questions, please contact your APRA supervision team.

Yours sincerely,

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