

EXAM 6 – CANADA, FALL 2012

28. (2.5 points)

a. (1.5 points)

According to OSFI Guideline E-18, “Stress Testing: Sound Business and Financial Practices”, describe three purposes that an institution’s stress testing program should serve.

b. (1 point)

With respect to stress testing programs, identify two responsibilities of senior management and two responsibilities of the board.

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total Cap available = $76,000 + 1,000 + 5,000 - 500 = 81,500$

total Cap required = $20,000 + 6150 + 450 + 10 = 26,600$

$MCT = 81500/26600 = 306.4\%$

The MCT is above internal target and company just needs to monitor that it stays this way now and in the future

Examiner's report:

This question was generally responded to well, with many candidates receiving full credit.

The most common mistake was that candidates were lumping company ABC and XYZ together in calculating capital for reinsurance ceded to unregistered insurers. Some other responses that lost points related to capital available and capital for UPR for not taking the max between the UPR and WP.

Question 28

Answer key:

- a) An institution's stress testing program should serve the following purposes:
- Risk identification and control – stress testing should be included in an institution's risk management activities at various levels, for example, ranging from risk mitigation policies at a detailed or portfolio level to adjusting the institution's business strategy.
 - Providing a complementary risk perspective to other risk management tools – stress tests should complement risk quantitative methodologies that are based on complex, quantitative models using backward looking data and estimated statistical relationships. As stress testing allows for the simulation of shocks which have not previously occurred, it should be used to assess the robustness of models to possible changes in the economic and financial environment
 - Supporting capital management – should form an integral part of institutions' internal capital management where rigorous, forward-looking stress testing can identify severe events
 - Improving liquidity management – stress testing should be a central tool in identifying, measuring and controlling funding liquidity risks.

Additional possibilities:

- A) Evaluate the effects on an institution's financial condition of a set of specified changes in risk factors
- B) Important after long periods of benign economic and financial conditions
- C) A key risk management tool/technique (during periods of expansion)
- D) Determine the impact of situations where the assumptions underlying established models break down
- E) Identify threats and potential management actions to address them
- F) Provide guidance on what risks are most likely to impact the financial condition

b) Senior management is responsible for:

- Implementation of stress testing program
- Management of stress testing program
- Oversight of stress testing program
- Ensuring that the institution has adequate plans to deal with remote but plausible stress scenarios

The board must ensure that:

- Must be aware of key findings of the stress tests
- Its senior management has in place a “fit for purpose” program that is enterprise wide
- Management has adopted policies requiring appropriate use of stress testing as a management tool

Additional possibilities:

The management –

- 1) identify and clearly articulate the institution’s risk appetite and understand the impact of stress events on the risk profile of the institution
- 2) participate in the review and identification of potential stress scenarios
- 3) contribute to the development and implementation of risk mitigation strategies

The board –

- 1) has ultimate responsibility for the overall stress testing program

Actual candidate answer for full marks:

- a) – risk identification and control: stress testing should address institution wide risks and interactions between risks
– provide a complementary risk perspective to other risk management tool: can be used to validate other statistical models
– improve liquidity management: assess liquidity risk profile of company and liquidity buffers
- b) Senior Mgmt → design/develop/implement stress testing programs
→ develop mitigation strategies and plans
Board → ultimate responsibility of program
→ review/approve results

Examiner’s report:

- a) Candidates were able to provide a list of purposes for the most part, but fell short when the time to give explanations came. This is not hard to understand as the descriptions in Guideline E-18 are sometimes not as intuitive as they could be (and it appears that candidates tried to replicate them as opposed to explaining them in their own words).
- b) A variety of answers was provided to this question, and the graders observed that generally, candidates confused Management’s responsibilities with the Board’s. Additionally, very few candidates provided the answers in the answer key for the Board’s responsibilities, but a large number of candidates came up with other acceptable answers.

Question 29

Answer key:

- a) The insurer's financial condition is satisfactory if throughout the forecast period it is able to meet all future obligations under the base scenario and all plausible adverse scenarios (assets > liabilities), and under the base scenario it meets the minimum regulatory capital requirement (MCT >100%).