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Credit Risk monitoring as part of the wider regulatory regime

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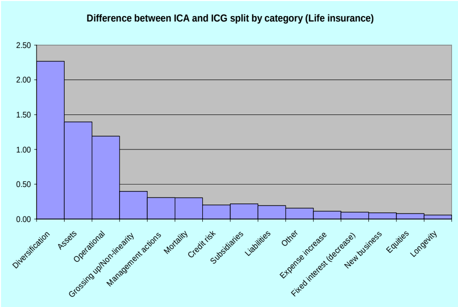
What I aim to cover

- Credit Risk in the context of ICA
- Traditional and Structured Credits
- How do current regulations hinder/ support good risk management
- Recent events in credit markets

Credit risk in the context of the ICA

£bn	General insurance		Life insurance	
Market	1.8	13%	25.3	47%
Credit	1.1	8%	6.9	13%
Insurance	9.5	68%	13.9	26%
Liquidity	0.0	0%	0.2	0%
Operational	1.5	10%	4.7	9%
Group	0.1	1%	0.8	1%
Other (risk related)			1.5	3%
Total	14.0	100%	53.3	100%

Credit risk in the context of the ICA



Credit risk in the context of the ICA

- Credit risk is a key risk for some firms but a minor risk for others
- ….after taking into account mitigation
- FSA tries to take a proportionate approach
- And normally broadbrush initially, relying on firms to provide detail required so that ICG is correct

Credit risk in the context of the ICA

- Setting a 1/200 stress test is not easy
- The approach should be proportionate to the risk
- Other tests might be available to sense check the main test
- Perhaps consider a number of defaults to check spread widening

Credit risk in the context of the ICA

- Reference points are used to make an initial assessment of ICA capital
- FSA reference points were set for a typical firm after considering academic research, recent experience and professional advice commissioned
- They are kept under review and will be updated as appropriate

Credit risk in the context of the ICA

Firms should also keep their stress tests under review and updated where appropriate

- In line with market good practice
- Considering new information including research
- Taking into account changes to their risks

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Credit risk in the context of the ICA

Difficult areas include:

- Liquidity premium
- Reinsurance
- Structured credit products

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Traditional and Structured Credits

- Life insurers' Other fixed interest securities at 31/12/2006 = £206,580m
- Life insurers' exposure to structured credit products at 30/6/07 = £1,153m
- The industry exposure to structured credit products is comparatively small and concentrated in a small number of groups and firms.

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Traditional and Structured Credits

- Recent work indicates that traditional credit risk is well-managed by life insurers.
- No significant issues with ICAS
- Letter to CEOs dated 9/8/2004 following thematic work conducted in 2003/4 identified good practices and few weaknesses

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Traditional and Structured Credits

- Concerns about structured products focus on whether firms properly understand the proposition and can price and manage the risks.
- Including setting capital both for ICAS and for their own risk appetite

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Traditional and Structured Credits

- Structuring can create AAA products out of 'junk' bonds by having protective tranches taking the first x% of defaults, at outset.
- But if after a period defaults have burned through this protection the products will then be expected to behave like 'junk'.
- Higher spreads = greater risks?

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Traditional and Structured Credits

- Provided a firm has sufficient expertise there is no reason why it should not invest in structured products
- Firms with significant holdings should be able to explain and justify the capital within their ICA covering the risks implicit in these assets
- And document this in the ICAS process

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Regulation and risk management

- Regulation should support good risk management and is certainly not designed to hinder it
- FSA has stated it intends to move to more principles-based regulation
- One perceived benefit of this move is to enhance the support for good risk management provided by regulation
- Rules-based regulation might cause too much focus to be given to compliance and too little to managing risk

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Regulation and risk management

- Favourable comment in an FRC Survey Report of July 2007, for example:
- *"NEDs attribute the positive changes … many of which have been driven by the FSA's requirements on risk monitoring."*
- *"… the big shift in my view has been the risk assessment that has to be done inside the company is being driven by the FSA."*

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Regulation and Risk Management

- The role played by firms in shaping the current regulations is acknowledged
- Firms should continue to play a positive role by suggesting through established channels of communication how regulation might be improved
- Particularly if they feel any specific areas are a hindrance to their risk management

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Regulation and Risk Management

- Risk management should be an area where firms' interests and regulators' interests share much common ground
- We need to ensure we build on this in developing regulations that support these common interests

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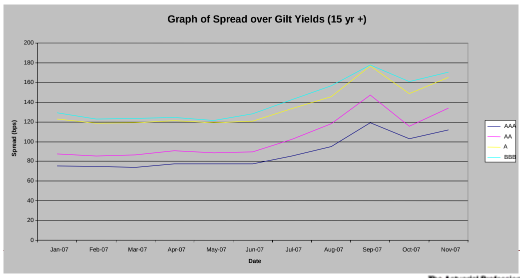
Recent events in credit markets



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Recent events in credit markets

What are the implications for life insurance?

- Investments
- New business
- Existing business
- Capital/Solvency cover
- ICAS

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