The Actuarial Profession
making financial sense of the future

GIRO conference and exhibition 2010
Martin White

Can we help?

Banks: reserving for bad debt

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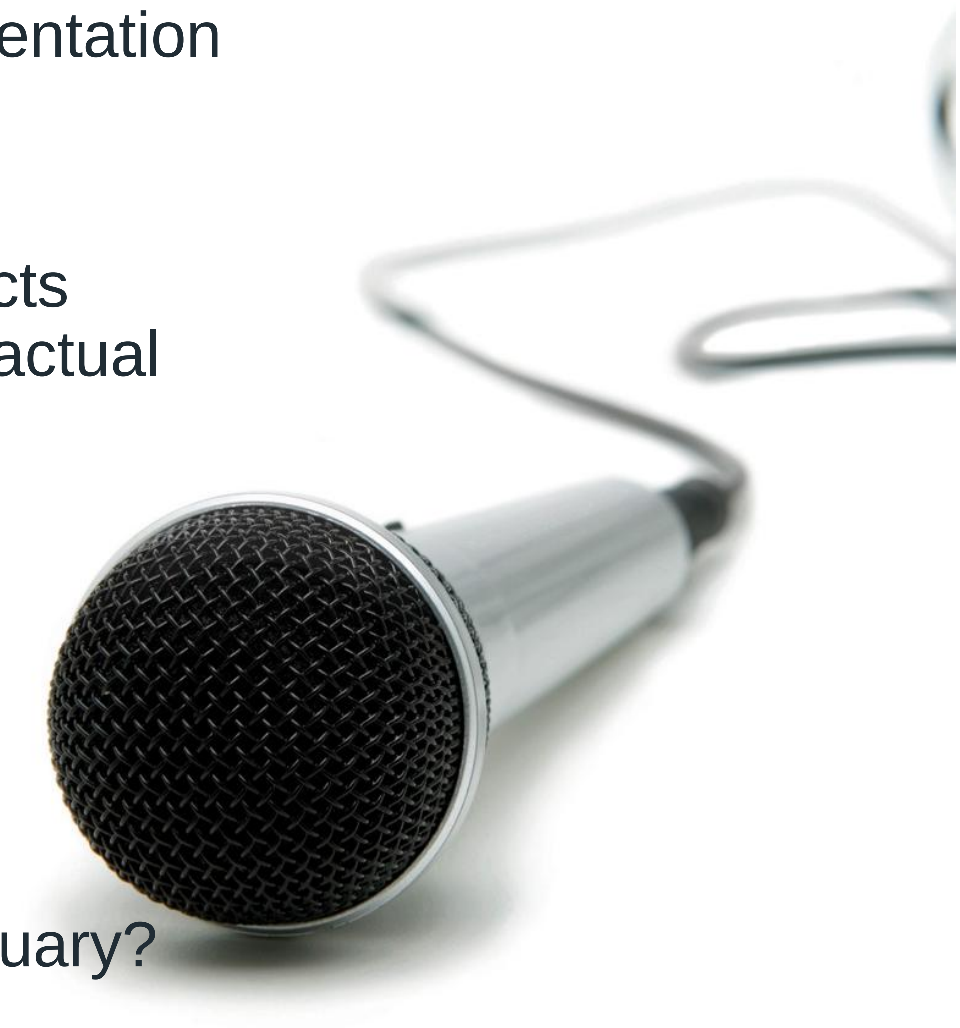
Tentative nature of today's discussion

Any views expressed in this presentation are those of the presenter alone.

And are capable of change as facts emerge! There may be serious factual errors in this presentation.

Can / should we research this area further?

Suggest quick project to gather information and share via the Actuary?



Background – what motivated this workshop? Well, it wasn't just "looking for more jobs for us"!

Wonder at how the banks could have been allowed to get it so wrong, for their financial statements to depart so far from reality

Wonder at why/whether they might have wanted to get it so wrong

The thought that, though nobody has thought of asking for actuarial involvement, perhaps we could help, in the non-life tradition of being prepared to have a go whilst being well aware of the limitations of our insights.

This **could** be a useful contribution – and might be fun to investigate, without wasting too much time if fruitless.

Banks: reserving for bad debt – can we help? Why? Banking and insurance into context

Equitable life – how serious? Consequences?

- Penrose
- BAS – impact on actuarial profession
- National impact?

Banks: reserving for bad debt – can we help? Why? Banking and insurance into context (2)

Banks – how serious? Consequences?

- Bank of Scotland / HBOS / Lloyd’s
- Northern Rock
- HSBC
- RBS

Blame Game (huge fun and column inches for journalists)

- Discuss?

Economic impact

- ???   Which heads have rolled?
- Compare with Equitable!

Banks: reserving for bad debt – can we help? Some background issues – is banking special?

The world is full of unintended consequences

- Tax code – "general provisions" not allowed
- Why not? How come IBNR is permitted for insurance?
  - Or is it simply that the level of evidence / professional assurance which is required in the case of IBNR is not always present for bad debt reserves
- Accounting standards: IASB "incurred loss" principle replaced UK ASB "expected loss" principle for group accounts, Europe too.
  - But UK implemented this for all banks, not just group level
- Compare UK company law – prudence, protection of creditors.

Banks: reserving for bad debt – can we help? Some background issues – is banking special? (2)

Professional involvement

- Insurance (non-life) *(life is even less comparable to banking)*
  - Actuarial involvement (only deepened relatively recently)
  - Some past scandals, gave rise to more formal actuarial role
  - EU – Sol2 – element of over-reaction?
  - And Sol2 in part inspired by Basel hype, "success" of internal models, Sol2 train left station before bank model discredited.
  - Huge danger of Sol2 being seen as expensive over-confidence
- Banking
  - No comparable professional exams for core element of bus?
  - But not suggesting that there is no academic or tech thinking

Banks: reserving for bad debt – can we help? Themes in common with the non-life world

Team role and credibility

- Importance of understanding the underlying risks
- We are not “the expert” on the span of non-life insurance, and it is essential to play a “team member” role, as well as to understand enough of the roles played by others
- You have to learn a lot about the underlying business to be credible in non-life: it’s not just a matter of crunching numbers
- But, with a few rare exceptions, we would be starting at absolute zero in banking
  - This is obviously something to research
  - Humility essential!

Banks: reserving for bad debt – can we help? Themes in common with the non-life world (2)

Personal lines / commercial lines / cats and reinsurance

- Parallels are retail lending, commercial lending, and we might think of all of the financial instruments and mechanisms for transferring / repackaging credit risks as similar to reinsurance (but nastier and even more opaque?). Utmost good faith?

Credit risk / banking type risks do already exist in insurance in a small way

- Credit insurance / surety bonds
- Mortgage indemnity guarantee
- And many of us will remember how MIG blew up in late 80s/early 90s – it didn't behave like "ordinary" insurance!

Banks: reserving for bad debt – can we help? Themes in common with the non-life world (3)

Go back 30+ years in non-life in UK?

- US already had rate-filing, of course, so an actuarial role there
- Were we welcomed at first?
- Remember it was tax that opened the door, but evidence of commercial value added that caused the huge growth of actuarial involvement in the UK.
- Contrast the roles created by regulatory requirement?
  - More future in banking for actuaries than S2-created work?
  - Perhaps not politically correct to ask this
- But which industry needs more radical change, insce or banks?

Banks: reserving for bad debt – can we help? And the differences?

Cultural – we would start from zero

- But there is some peripheral actuarial involvement already
- Witness the “action group for banking” (AGB)
- But the AGB has not focused on the bad debt reserving, which is arguably at the core of banking, just as claims reserving is for insurance.

The nature of the claims? Bank loss come from asset failure

- Non-life claims do have a calendar element, and they have a catastrophe element
- But with banking, there is an “economic conditions” overlay to the individual claim factors. Extremely challenging.

Banks: reserving for bad debt – can we help? Some challenges / barriers

- Learning the jargon and getting the opportunity to help at all
- But perhaps there is scope for actuaries to support audit teams, in the big accounting firms? (accounting standards have arguably been an impediment so far!)
- Tackling the twin drivers of losses – risk-specific, and economic environment-driven.
- As an opportunity / distinction – the professional discipline and ethical values – what would we have done?

Banks: reserving for bad debt – can we help? Asking around

- “It’s great you’re looking into this”
- “My overall view is that a lot can be gained from applying actuarial techniques to loan loss reserving”
- “After the last two years, there have to be lessons to be learned…. Accounting requirements have played a big role …”
- “There is a good deal of knowledge out there on credit risk management… no single place to find it”
- “There are a large number of high powered “credit risk” people in the big banks, lots of PhDs etc”

Banks: reserving for bad debt – can we help? Asking around (2)

- There have been I of A sessions on "how the integration of insurance and banking techniques and thinking can add real value" – but getting hands dirty on bad debt not discussed
- There are no examinations / courses on bad debt estimation by or on behalf of the British Bankers Association (based on calls to BBA and their education providers – may be wrong conclusion)
- But Basel 2-related material on probability of default (PD) / loss given default (LGD) / exposure at default (EAD) is considerable.
- There is clearly something out there – but is there scope for us to contribute?

Banks: reserving for bad debt – can we help?
So what to do?

Would some limited further fact-finding be worthwhile?

- Small limited duration working party?
- Conduct series of interviews and discussions
- Produce small paper summarising conclusions
- Depending on conclusions, discuss with I and F what appetite to take forwards.
- Article in Actuary to share conclusions and test wider interest in taking forward?

Anyone interested?