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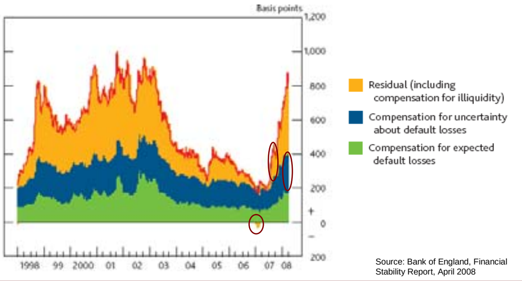
making financial sense of the future

Credit Crunch
Practical Implications for Life Insurance Actuaries

Paul Fulcher
UBS

Liquidity premia – good news?

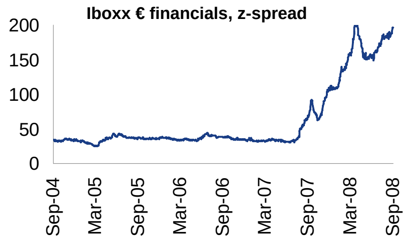
High yield bond spreads decomposition



Source: Bank of England, Financial Stability Report, April 2008

Capital raising

- Wide spreads, -ve basis, monoline problems



Source: UBS Delta

Lessons to be learned

- "We were seeing things that were 25-standard deviation moves, several days in a row.", David Vinair, CFO Goldman Sachs, August 2008
- "Not only can you not turn a toad into a prince by kissing it, but you can't turn a toad into a prince by repacking it", Warren Buffett, 2007
- "It has been said that democracy is the worst form of government except all those other forms that have been tried from time to time." Winston Churchill, 1947

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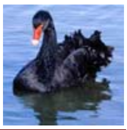
Risk management

- Historic models consistently underestimate "1-in-200 year" events
- Scenario planning and stress testing
- Tail correlations
- Expect the unexpected



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Hedging – and potential pitfalls

- Basis risk
- Counterparty risk
  - correlation to hedged risk
- Funding the Libor leg on swaps / collateral
- Policyholder behaviour and rationality

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Mark-to-market issues

- Dangers of mark-to-model on illiquid assets ...
- … and liabilities
- Reliance on external valuations …
- … and credit ratings
- Contingent / off balance-sheet exposures and structured assets

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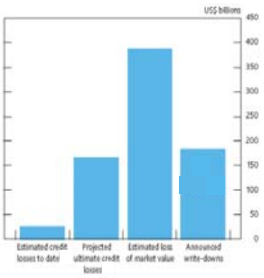
But did m-t-m exacerbate the crisis?



But credit losses from the turmoil are unlikely to ever rise to levels implied by current market prices unless there is a significant deterioration in fundamentals, well beyond the slowdown currently anticipated. That is because prices are likely to reflect substantial discounts for illiquidity and uncertainty that have emerged as markets have adjusted but which should ease over time. While market-based estimates and the write-downs announced by firms may be unduly pessimistic, if such concerns persist there is a risk they could become self-fulfilling.

Source: Bank of England, Financial Stability Report, May 2008

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