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To the Chief Executives
of Life Insurers and Friendly Societies

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Dear Chief Executive

Credit Risk Management in Life Insurance Firms

We are sending this letter to all life insurance firms we regulate, including friendly societies which are subject to the European Union Life Directives. We will publish it on our website on 13 August 2004.

We have recently conducted a thematic review of 10 life insurance firms to examine how life insurers manage credit risk. The purpose of this letter is to report our findings and to ask you to consider the practices within your own firm in some common areas of weakness.

Our conclusions are based on 10 firms, chosen to be representative of the larger life insurers in the UK.

Background - Our rules and guidance on credit risk

We regard sound risk management practices in the firms we regulate as extremely important. This is expressed in the FSA Principles. Principle 3 states "*A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems*". Rules and guidance on risk management are in the FSA Handbook, in particular in the sourcebook on Senior Management Arrangements, Systems and Controls (SYSC). We will also include further rules and guidance in the Prudential Sourcebook (PSB) for life insurers and non-life insurers. This will include both material on credit risk management systems and controls (see our policy statement *Integrated prudential sourcebook - Near-final text on prudential risks systems and controls*, October 2003) and on capital for credit risk in insurance (see our policy statement PS04/16, issued July 2004).

In addition, in October 2003 we published a paper, *Review of UK insurers' risk management practices*. This reported the findings of a survey of risk management practices and procedures in the UK insurance industry. Section 9 of the report identifies areas of weakness commonly found, and section 7 comments that "it is perhaps surprising that life insurers do not give these risks (reinsurance credit risk) a higher profile."

To build on the work of the October 2003 report we have recently completed a project to assess how credit risk is managed in the life insurance sector, and identify good practices. The thematic review on which this letter is based is part of this project. We have also compared what we have found with practices observed in the banking and building society sectors. Credit risk for this project has been defined broadly as the risk that money owed to a life insurer might not be paid in full on the due date. We have tried to consider any circumstance when this might occur, but have focused on those circumstances that are material to the life insurer. We found that many firms fully understood the credit risks to which they were exposed and had well-documented policies setting clear risk appetites for each different type of exposure. We list details of good practice identified in the appendix to this letter. However, we also discovered some areas of weakness.

Areas of weakness

Whilst the project findings generally indicated that credit risk is well managed in the life insurance sector, there are pockets of weakness:

- **Little or no separation of duties in determining the credit analysis and making investment decisions.** This might be inevitable in a small team. But there is a clear risk that the quality of the investment decision might be compromised if the decision makers had also made a personal commitment to the underlying credit analysis, particularly where they have also been involved in negotiating the terms of the transaction.
- **No independent review of in-house credit analyses outside of the investment team,** even on a sample basis. Whilst our specialist team regarded in-house credit analyses as being generally of high quality, analyses were often relied on to rate unrated exposures which in some cases made up more than 30% of the fund (including the rating of property lending and alternative instruments whose rating might be predominantly subjective). Dangers of incorrect analysis might materially affect the assessment of the overall credit quality of the fund.
- **No segregation of duties between policy implementation and compliance.** Those responsible for implementing investment policy, including credit risk aspects, were often responsible for monitoring and reporting on compliance with that policy without any apparent process in place for independent verification. This might allow serious breaches to be covered up or excessive risks to be taken for short periods.
- **Management information could be improved generally.** Firms did not always break out their exposure by credit rating or sector/country and if they did, there was little or no trend analysis of key performance indicators over time. Additionally it was not always clear that the management information was sufficient to allow senior management to monitor the total credit exposure of the firm as a whole.
- **No knowledge of total exposure to one counterparty/issuer.** System constraints in some firms prevented the aggregation of counterparty/issuer exposures across business

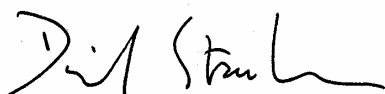
units. Some firms could find themselves with material concentrations to a troubled counterparty/issuer across the whole business without being aware of their aggregate exposure.

- **Little evidence that liquidity risk is mitigated.** The market for some quoted bonds is thin and there is doubt that holdings could actually be sold at or near the quoted prices used for valuations. But there is little evidence of measures being taken to identify and mitigate this liquidity risk. Good practice observed in this area included reviewing screen prices for movements indicative of active trading, requesting quotations for the sale of all, or a significant proportion, of a holding, and assessing and holding an appropriate reserve where the market for a particular holding appears to be illiquid.
- **No mitigation of credit risk from older reinsurance contracts.** Whilst new and recent contracts for the transfer of risk to reinsurers have regard to credit risk and generally include mitigating features, there are large volumes of older business of significant size and importance that expose firms to considerable credit risk without mitigation. Whilst reserves should already be held against this credit risk you should also consider the implications of such arrangements for future reserving requirements and Individual Capital Assessments as discussed in our recent consultation papers and policy statements, in particular Consultation Paper 195 – *Enhanced capital requirements and individual capital assessments for life insurers* – and Policy Statement 04/16 – *Integrated Prudential sourcebook for insurers*.

We ask that you consider your firm's credit management processes to see if improvements could be made in the light of the industry good practice identified in the appendix or the areas of common weakness outlined above. We recognise that some of the common weaknesses listed above for larger firms might not be recognised by smaller firms, either because they have no exposures to the particular risk areas or because they outsource the management of the risk. In the former case the issue is clearly not relevant. In the latter case we ask firms to consider if the weakness is present in the outsourced processes or in the interface between them and the outsource service supplier, and, if so, how corrective action should be taken. In future risk assessments of firms we will be taking into account the extent to which risk management processes meet the rules and guidance in the PSB, and how they measure up to good practice seen within the life insurance sector.

We also ask you to consider the capital implications of your reinsurance program and other credit risk exposures under CP195 requirements. If you have any doubts about what the proposed new regulations mean for the capital your firm will need to hold against this credit risk, please raise these with your supervisor.

Yours sincerely,



Appendix

Good Practice identified within firms visited

The following has been identified as constituting good practice observed for the management of credit risk exposures within the life insurance sector, based on visits to selected firms made as part of our project.

Risk Appetite

- Statement of risk appetite carefully drafted within an Investment Management Agreement in terms that enable senior management to determine whether or not the fund meets the risk appetite criteria at any time.
- Benchmarks or indices together with any other rating constraints designed to control both the incidence of credit risk and to prevent subsequent credit erosion within the fund. These also lay down the maximum extent to which the risks taken on at any time are allowed to depart from the benchmark risks.
- Clear limits set for exposures to currencies, countries and market sectors.
- Clear limits set for the percentage of the fund that can be exposed to any one issue or any one counterparty or group of connected counterparties.
- In the context of liquidity, clear limits set for the maximum percentage of any single issue that can be held.

Senior Management Oversight

- Senior management have an overall understanding of the credit risks implied by the risk appetite, and the credit quality of the fund.
- Senior management receive verification of compliance with risk appetite from sources independent of those responsible for implementation of policy.
- Senior management receive management information that is sufficient to identify breaches of compliance with policy, and to identify trends in key performance indicators.

Management Information

- Shows amounts of exposure within each rating grade (including identifying the extent of exposures that are not rated by external rating agencies).
- Shows exposures by currency/country/sector.
- Shows aggregate exposures to large counterparties including exposures from all possible different sources which could include corporate bonds, equities, cash deposits, reinsurance, commercial property investments and loans (including tenant exposures),

stock lending, collateral, credit derivatives, and the underlying exposures within structured products or collective investment schemes held.

- Shows aggregation of material exposures to specialist (monoline) insurers which provide enhanced credit ratings for bonds and other financial instruments by guaranteeing payments.
- Monitors fund manager performance against benchmarks/indices and any other rating constraints and analyses tracking errors (analysing those errors into component parts if appropriate).
- Shows trend information on the credit quality measures above.
- Shows watch list of credits where management action is, or might soon be, required.

Investment Management (of credit risks)

- There are measurable and achievable performance targets for investment managers and/or funds. Good practice observed included a target to exceed the total return on a benchmark gilt portfolio whose duration is the same as the target duration of the actual portfolio. Risk constraints were imposed on the portfolio, and an adjustment to the yield to allow for any change in the overall level of credit spreads for risks of appropriate credit quality over the measurement period was specified.
- There is segregation of credit analysis and fund management, or equivalent control processes to monitor the objectivity of analysis and the independence of fund management decisions where teams are too small to make segregation practical.
- There is a control on the quality of internal analysis for non-vanilla investment decisions, for example alternative instrument classes including commercial property lending and leveraged loans.
- There is regular monitoring of analyst performance by systematically recording credit analyses and recommendations and subsequently comparing predictions made with actual events. In the context of providing internal ratings for non-rated exposures this record forms part of the rating audit trail.

Risk Aggregation

- Aggregate exposures to each counterparty/issuer across business silos (see above in Management Information) are measured against appropriate limits determined for each counterparty/issuer.

Reinsurance/Stock Lending/Cash

- Counterparty limits are set that take into account the counterparty's credit rating and credit loss mitigation measures are in place.
- Extent and quality of collateralisation requirements set take account of the counterparty's credit quality.

- Review processes are in place with specific triggers including frequency, extent of exposures, credit events relating to the counterparty and any other material factors.
- Procedures are documented.

Property/Alternative Instruments/Credit Derivatives

- Limits apply to exposures to direct counterparties (for property lending) and to tenants that take into account the credit rating of tenants (for property investment).
- Limits for maximum exposures are documented. Tenant and property type concentrations are monitored and capped.
- The property lending activity policies in place set transaction parameters (such as loan to value ratios, rental cover, duration of the loan, residual values limits etc), lending approval mandates, facility review and documentation requirements.
- Rating methods are set and documented for both property lending and alternative investment classes such as leveraged loans.
- Controls over analysis processes are in place and used effectively, including a governance structure to provide a robust challenge to investment proposals put forward.

Default Reserves

- There is a documented process for setting reserves (capital) that takes into account historic default and transition data, and allows for future experience to be significantly worse than the average of the historic experience.