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UK Banks and Life Insurers

A comparison of risks faced by each

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Overview

- If banking and life insurance professionals are to learn from each other, it is important to understand the similarities and differences in the risks faced by each.
- In some ways, UK life insurers and banks have very similar business models – both take money in from investors (policyholders / depositors); they invest (/ lend) these funds and earn a margin (management charge / interest spread) over what is credited back to investors.
- However their purpose is different – banks have a key role in providing liquidity to the economy through lending; while life insurers role is more about long term savings and protection.
- Banks also differ in having a strong high street presence while life insurers tend to rely on IFAs for distribution.
- Life insurers also differ in presenting results on an embedded value basis in their accounts, crystallising future margins on business written.

Market Risk – Banks

- A key market risk for banks is lending at fixed rates where there is the option to redeem at par.
- However for UK banks, this risk is mitigated by the short term of fixed rate offerings, redemption penalties and interest rate hedges.
- UK banks will typically have trading desks which arrange hedges as well as dealing on their own account. The latter risks are well controlled, with systems capable of daily monitoring of VaR against limits while positions can usually be closed out within a fortnight.

Market Risk – Life Insurers

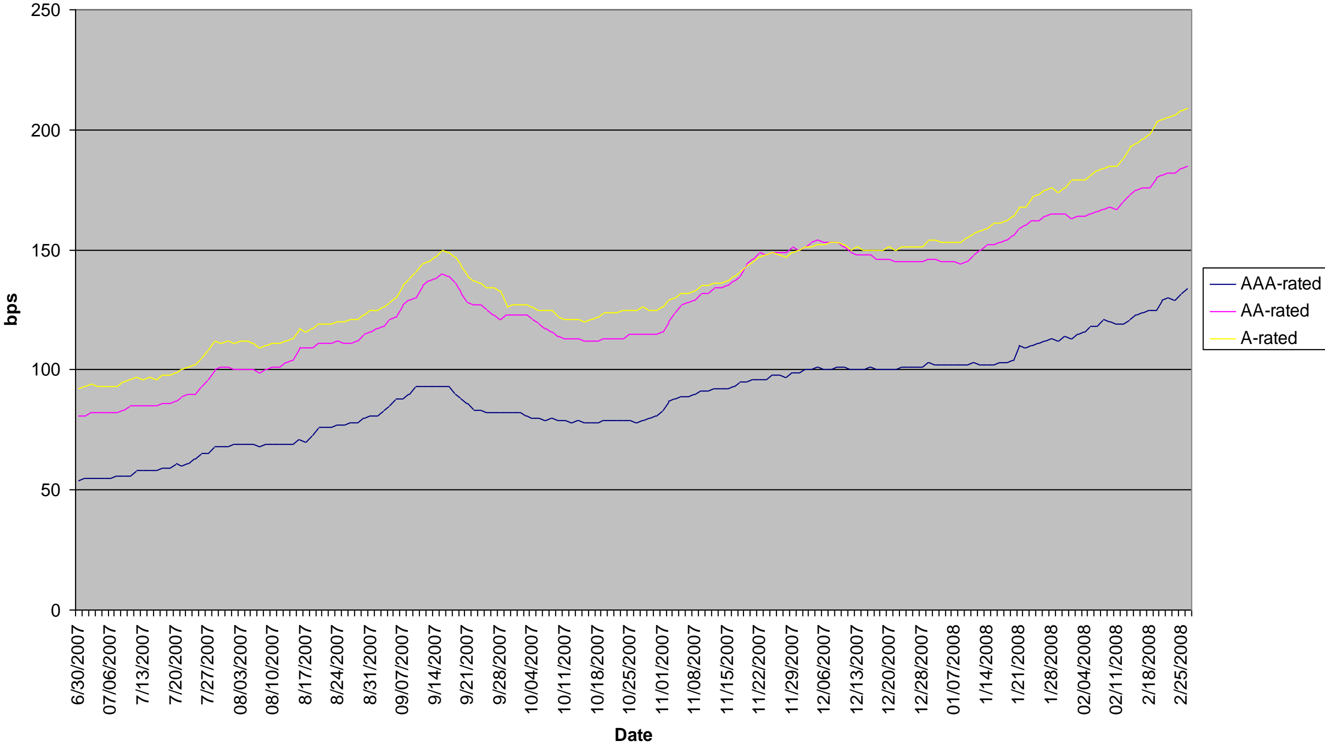
- UK life insurers by contrast have considerable unhedged market risk exposure in respect of With-Profit Funds where there is a mismatch between the nominal guarantees typically offered with such policies and policyholder expectations that policies will be invested in real assets like equities and property.
- There is also the expectation of regular bonus additions to guarantees.
- Valuation is complicated as the investment mix and bonus additions are set at an aggregate level, meaning policies can't be valued on a stand-alone basis – the whole office must be projected simultaneously.
- Embedded values (of future management charges) are also vulnerable to market shocks, and difficult to hedge.
- Banks and life insurers do have a common market risk exposure in respect of final salary pension schemes.

Credit Risk

- For life insurers, the main credit risk relates to corporate bonds but these are generally investment grade and can be readily traded. The focus is on managing credit events such as takeovers and downgrades rather than defaults.
- Credit risk is a key risk for banks. Managing this is a core competence, particularly as the credit risk attaching to loans and mortgages is not readily transferable. As a result, banks tend to have strict lending criteria and much more detailed lending policies and exposure limits than life insurers in order to manage credit risk.
- However in recent times, banks have become adept at securitising their loans. Unfortunately some banks let standards slip as a result. The resulting rise in loan defaults and uncertainty as to who bears these losses has lead to recent market turbulence with rises in bond spreads – which affect life companies – as well as LIBOR.

Credit Risk

Credit Risk



Insurance Risk

- Life insurers are exposed to mortality (death) and morbidity (sickness) risk on protection products, as well as longevity risk (of people living longer) on annuities.
- While banks may not appear to be exposed to these risks, sickness and death can affect loan repayment, though this is mitigated if the borrowers takes out PPI.
- Banks may also be indirectly exposed to general insurance risk through subsidiaries or profit share arrangements.
- Banks are exposed to longevity risk on lifetime mortgage lending as the “no negative equity” guarantee will increase in value the longer people live.
- Finally both banks and life insurers have considerable longevity exposure through their final salary schemes.

Persistency Risk

- UK life insurers incur high commission and other up-front costs. Product regulation and market pressures mean that current products may take a number of years before these costs are recouped.
- Higher than expected lapses also lead to a write-down of embedded values, leading to adverse analyst comment.
- Banks do not experience such write-downs of expected future margins, but persistency is arguably as important as credit risk in terms of economic value, as early loan redemptions lead to a loss of future interest margins on that loan.
- Higher than expected retail deposit withdrawals may also have a cost if these have to be replaced by more expensive wholesale funds.

Expense Risk

- UK life insurers face considerable risk in relation to the expenses incurred over the term of policies, as stricter regulation of With-Profits and Unfair Contract Terms regulations (UTCCR) have limited the scope to increase charges to address cost overruns.
- They at least do not have to deal with the heavy ongoing fixed cost of a retail branch network.
- However for banks, there is usually scope to address cost overruns by increasing interest margins and varying charges, though the former is constrained by competition (and is not an option on tracker mortgages) while the latter may be constrained by current UTCCR challenges.

Liquidity Risk

- This is a key risk for banks who borrow short (e.g. instant withdrawal deposit a/c) and lend long (e.g.25-year mortgage). In particular, there is a risk of a run of deposit withdrawals leading an otherwise solvent bank to ruin.
- Banks devote considerable resources to liquidity scenario testing and are adept at securitising otherwise illiquid assets such as mortgages. However Northern Rock highlighted the problems of relying on securitisation as a source of funding.
- UK life insurers by contrast have little liquidity risk as they take in long term savings and invest in marketable assets. Moreover, until recently most insurers had surplus premium income over claims.
- However Equitable Life showed the possibility of mass surrenders akin to a run, albeit more protracted.

Operational Risk

- UK life insurers have incurred considerable losses from the misselling of pension and mortgage endowments, often by banks acting as their Appointed Representative. Life insurers have tightened up systems and controls as a result, and will generally no longer bear the risk of banks misselling their products.
- Banks face ongoing losses from external fraud, but with tightening controls (e.g. chip & PIN) there are now indications that fraudsters are turning to life companies.
- Both banks and life insurers face regulatory challenges to charges, but for life insurers, the immediate impact would be more pronounced as this will lead to a write down of embedded values.

Operational Risk

- Under Basel II, from 2008 operational risk will form part of bank's "Pillar I" minimum regulatory capital.
- Many banks are considering adopting the AMA approach to operational risk capital, based on internal models, and are investing heavily in operational risk evaluation, loss capture and modelling.
- Operational risk does not currently form part of life insurers regulatory capital (though it is likely to under Solvency II), but is currently covered under ICA (akin to the Basel II "Pillar II" ICAAP) and is a key source of additional capital "add-ons" by the FSA.

Aggregation – Banks

- For UK banks, credit risk is the most significant risk, though arguably persistency risk is as significant in terms of economic value destroyed.
- Market risk is substantially hedged while expense risk is not presently a problem due to bank's flexibility in recouping costs.
- Operational risk, while it may be significant on a stand-alone basis, may only make a modest contribution to post-diversification economic capital if low correlation is assumed.
- Liquidity risk, while very important, is more properly addressed by ensuring access to lines of credit rather than holding capital.

Aggregation – Life Insurers

- For UK life insurers, market risk is usually the largest risk, followed by persistency risk.
- Insurance risk will be large but generally taken as uncorrelated with these, so its contribution to diversified economic capital may be modest. However for some insurers with large annuity and / or term assurance books, it may be key.
- Credit and expense risk may be significant, particularly if they are assumed to be correlated with market risk.
- Operational risk may also be assumed to be correlated with market risk due to the impact of market falls on misselling claims. For some linked life offices with significant legacy misselling exposure, operational risk may even be the most significant risk faced.
- Liquidity risk economic capital requirements will be minimal.

Conclusion

- While there are some significant differences, UK banks and life insurers can usefully share experiences as well as tools and techniques for managing risk.
- For example, banks could learn from life insurers approach to quantifying persistency losses, as well as the impact of longevity on their pension schemes.
- Banks have a lot to teach life insurers in terms of management of credit risk, as well as securitisation techniques to pass on risks to the wider market.
- UK life insurers, in terms of their misselling experiences, the limitations they face under UTCCR, and product regulation, may offer an uncomfortable example to banks of adverse regulatory intervention.