

Credit Risk

Current Thinking

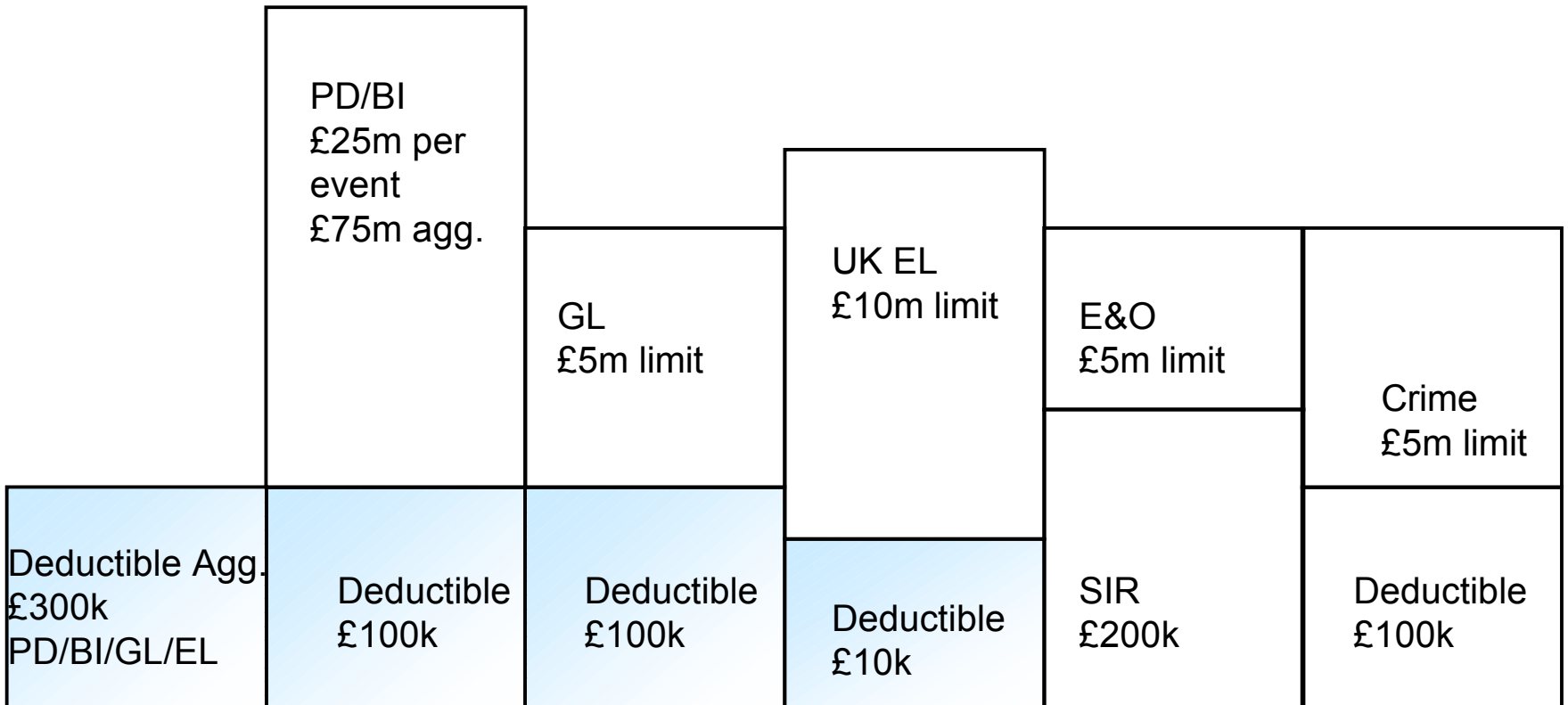
What is Credit Risk?

Credit Risk is the *non-insurance financial risk* that an insurance company incurs in the provision of an *insurance contract*.

How Does Credit Risk Arise?

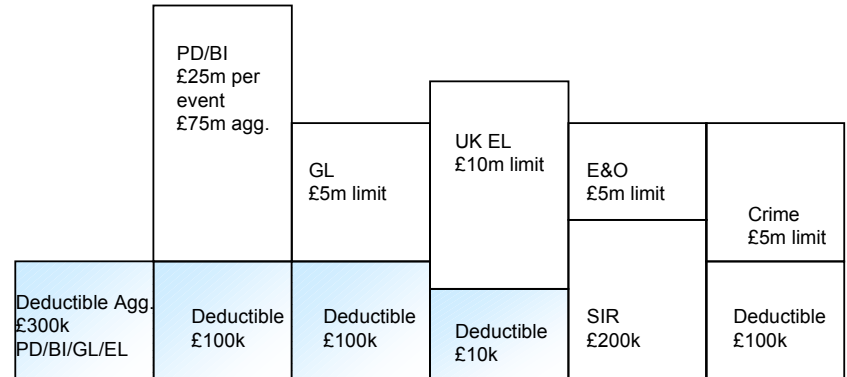
1. Deductibles
2. Captives
 - Gross Cession
 - Net Cession
3. Reinsurance

Deductible Structure

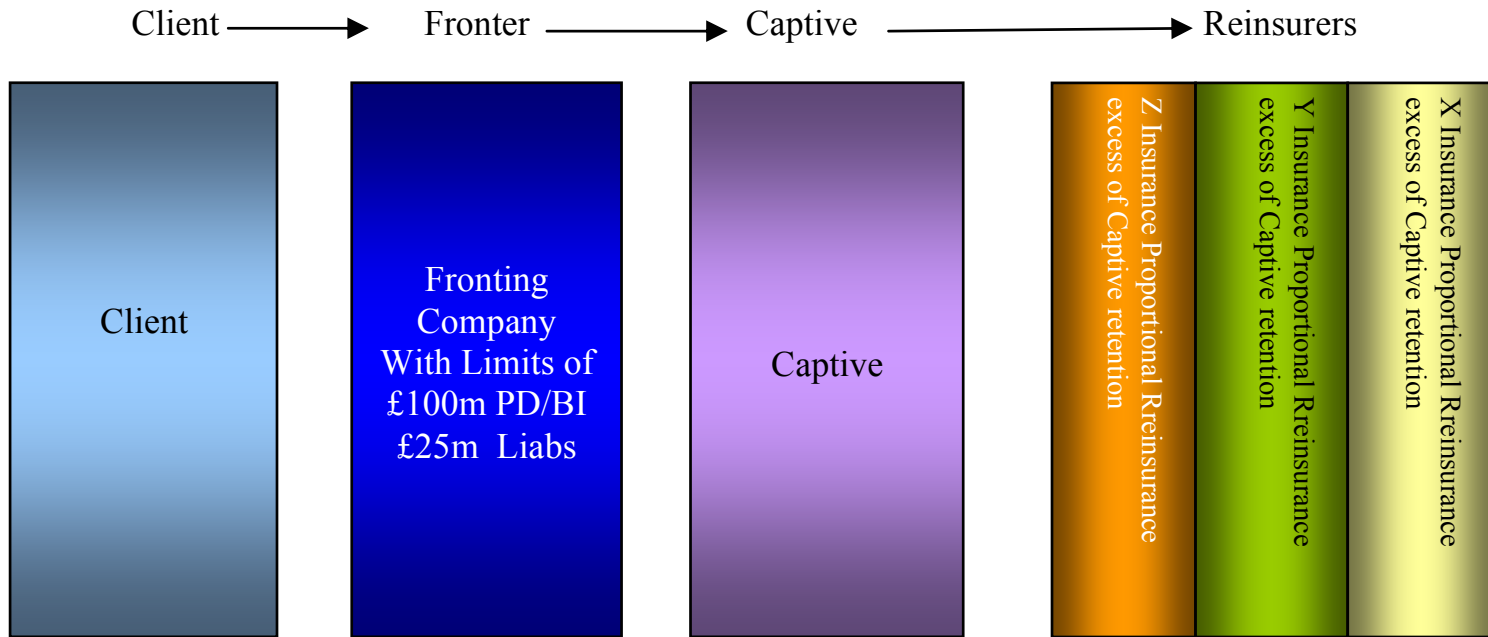


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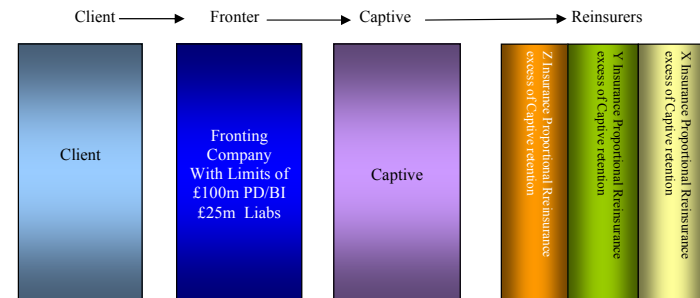
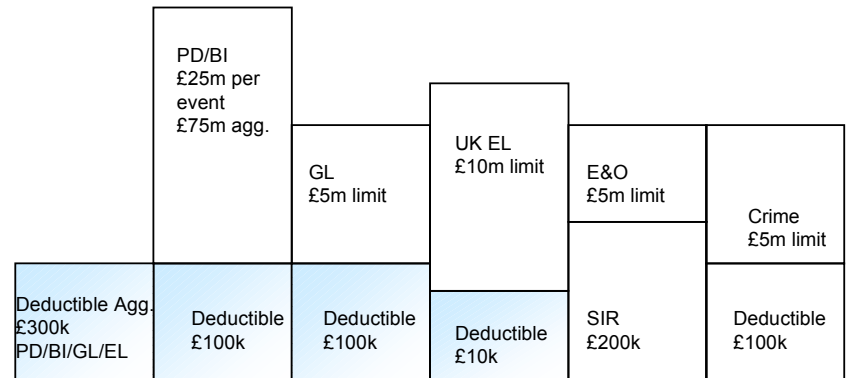


Gross Cession Captive

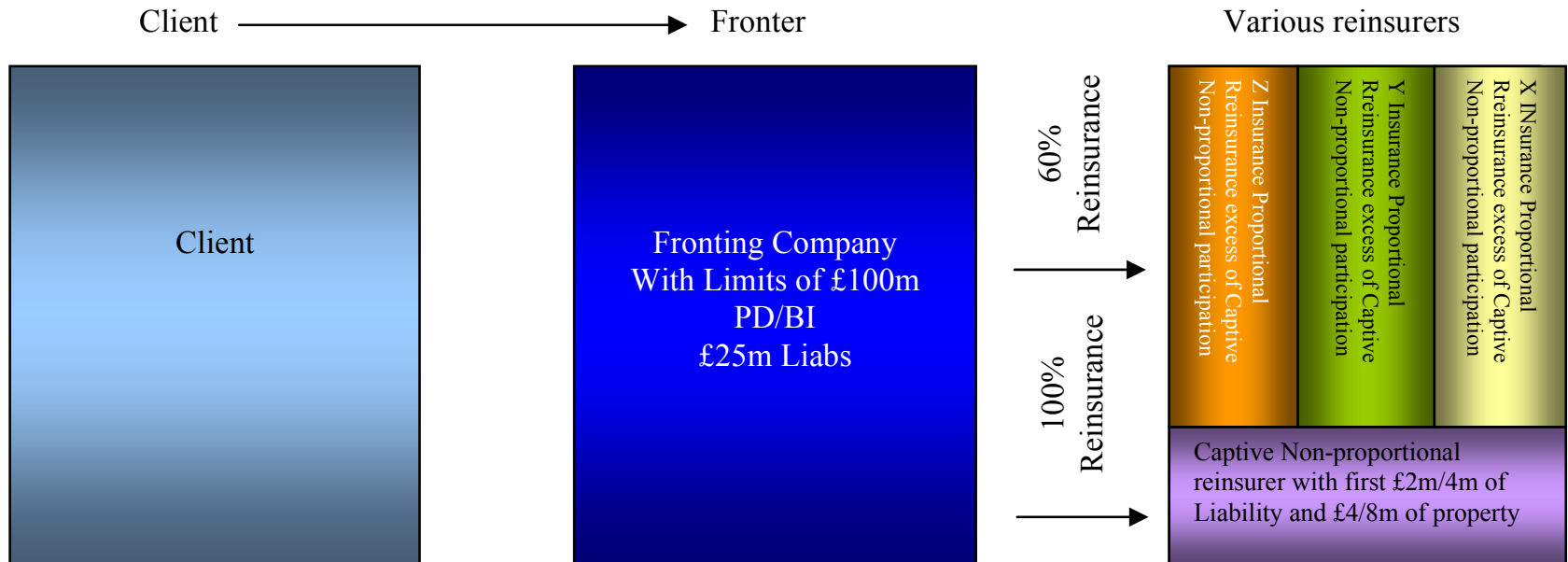


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1. Deductibles
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Gross Cession
Net Cession
3. Reinsurance



Net Cession Captive



How is Credit Risk Calculated?

- Aggregate of retention (deductible or Captive)
- Expected Losses
- Expected Losses less paid claims
- If aggregate is £12m in total that is the credit risk
- If expected losses within the £12m are £8m that is the credit risk
- If expected losses are £12m and paid claims are expected at £3m, the credit risk is £9m.

Credit Mitigation Instruments

1. Letter of Credit
2. Surety Bond
3. Trust Fund
4. Cash
5. Advance Concession Agreement
6. Simultaneous Payments Clause
7. Security Trustee Assignment
8. Reinsurance Cut-through Clause
9. Parental Guarantee

Impact on Insured Clients

- LOC
- Cash and Cash in trust
- Security Trustee Assignment

Impact on Insurance Companies of Credit Risk

Unsecured Credit Risk impacts capital requirements:

1. Risk Based Capital requirements
2. Rating Agencies
3. Solvency II

Risk Based Capital

- Asset Risk
- Credit Risk
- Underwriting Risk
- Off-Balance Sheet Risk

Risk Based Capital & the FSA

- Minimum Capital Requirement (MCR)
- Enhanced Capital Requirement (ECR)
- Individual Capital Adequacy Standards (ICAS)
- Individual Capital Guidance (ICG)

Rating Agencies

Risk Assigned Capital

Solvency II

- Underwriting Risks
- Default risks
- Investment risks
- Operational risks

Conclusion

Credit Risk is non-insurance risk

Captive and client retentions generate credit risk

Collateral reduces credit risk

Collateral carries cost

Credit risk is set to become a bigger issue for insurers with FSA and Solvency II regulations