

Highlights of the 2009 ICA Credit Stress and Illiquidity Allowance survey

Setting credit stresses has become one of the hardest parts of ICAs in recent years due to changing market conditions and the increasing risk of bond defaults. Models that worked in previous years are not necessarily appropriate any longer, whilst at the same time there has been increased focus on insurers' capital positions, and their ability to withstand large-scale defaults in their corporate bond portfolios. Similarly, the size of liquidity premiums used in valuing annuity liabilities has also been an area of interest for insurers and the FSA.

In April and May 2009, Watson Wyatt compiled a survey into the credit stress tests and illiquidity allowances used by insurers for whom these were significant assumptions in year end 2008 ICAs. The detailed survey is only available to respondents, but below is a summary of the responses.

Credit stress tests

There was considerable variety in approaches for deriving and expressing credit stresses between respondents. However, the following general patterns could be observed:

- All but two companies increased the strength of their credit stress tests. The remaining two had similar or the same strength tests.
- Despite the extreme market conditions at the end of 2008, all respondents used the same or very similar approaches to deriving their stress tests as for their 2008 ICAs.
- All but one respondent quoted their stresses relative to gilt rates as opposed to swaps.

- There was an even split between those whose stresses varied by duration, and those whose did not.

- Most respondents applied spread widening and default/downgrade risk simultaneously. Those that did not, applied them separately, and then either added the capital requirements, or combined them using a correlation assumption.

- The approaches used included combinations of:
 - ESGs, including multivariate stochastic modelling covering market and credit stresses
 - a modified Merton model
 - transition matrices
 - analysis of historical data
 - management and expert opinion
 - scenario analyses.

Illiquidity allowances

All respondents had significant amounts of (net of reinsurance) annuity liabilities, and so the application of liquidity premiums

is a material issue for them. All used a base ICA risk-free discount rate in the range of 0-10bps above gilts (including the one company that measures their discount rate relative to swaps).

All but one company allowed for a liquidity premium in their annuity discount rate. The size of the illiquidity uplift applied is considerably larger than last year, when the maximum liquidity premium was in the 81-100bp range. This year there was a wide dispersal of assumptions from the 120-140bp range up to and above 200bp.

The respondents were evenly split between whether or not they allowed for an increase in the annuity liability discount rate under the ICA credit spread stress. Those that did allow for an increase all captured around 50 per cent of the increase in spread as an increase in the liquidity premium. This may have been influenced by the conclusions from the Bank of England paper that the FSA has referenced when discussing liquidity premia (see the article on liquidity premia on page 6 for more details).