

Response to the Basel Committee SIGOR consultation paper: Recognising the risk-mitigating impact of insurance in operational risk modelling (November 2009)

Personal background

1. Following a career as a senior executive in banking, culminating in my appointment as Chief Risk Officer of Hill Samuel Bank Limited, I became a Director of the British Bankers' Association in 1996 where I was particularly involved in policy issues relating to operational risk, including negotiations with the Basel Committee concerning the new Capital Accord, and was the founding Chairman of the BBA's Global Operational Loss Database.

2. After I left the BBA in March 2003, I became a non-executive Director of Novae Syndicates Limited, a principal underwriter of financial institutions in the Lloyd's insurance market. I am a member of the Lloyd's Market Association Risk Committee and of the FSA's 'expert' groups for Solvency II and Solvency II operational risk. I have written and spoken frequently on the subject of insurance for operational risk, including a presentation to the CEBS NOVI-O group in January 2008 and presentations to underwriting and other sub-groups within the Lloyd's market. I also responded, in a personal capacity, to the Operational Risk section of the Basel Committee's CP3 published in April 2003. Although I am not a current banking or insurance practitioner, I have considerable experience of both banking and insurance, as well as Basel II and operational risk, and hope my response, which is again written in a personal capacity, will be of assistance to the Committee.

General observations

3. I welcome the SIGOR paper, which sets out the complexities of many of the issues about which I have commented over the last seven years and provides helpful guidance to supervisors, banks and insurers. Given my agreement with the great majority of statements made in the consultation paper, my response consists of a number of observations on specific sections, which are given below, the headings referring to those of the SIGOR paper.

4. First, though, two general observations. Whilst recognition of insurance as a mitigant to capital is only offered to AMA banks and this obviously forms the basis for the paper, there seems to be an underlying assumption in the paper that insurance, as a mitigant for operational risk, is only of interest to the relatively small number of AMA banks and that these banks' purchase of insurance will be driven by AMA requirements. Of course, as the Committee will be aware, all banks take out insurance for a variety of perils. The danger of not acknowledging this is that the insurance industry can be encouraged by banking regulators through the Basel regime to tailor existing products to be 'AMA-compliant', which then distorts the cover provided to all banks and not just to AMA banks. Of course, insurers should be robust in their unwillingness to change the terms and conditions of policies where they consider them to be imprudent, but the pressures from brokers (on behalf of their

bank clients) and the market could mean that any changes will affect the financial institution insurers generally and go beyond the small number of AMA banks.

5. My second general observation is that there also seems to be an underlying assumption in the paper that the AMA offer of capital mitigation will lead to additional insurance purchase, purely for the sake of some form of capital arbitrage, as described in section 4.1. In a well-run bank, with good operational risk of governance, management and culture, assessment of insurance requirements, based on a clear understanding of its operational risk exposure and operational risk appetite, may lead to increased reliance on self-insurance, in other words deciding that some classes of insurance can be allowed to lapse on cost-benefit grounds. It would have been helpful to reinforce the message that better operational risk management should lead to smarter insurance purchase.

Specific observations

3. Insurance industry supervision

6. All banks, whether AMA or not, purchase a wide variety of insurance policies (see Annex A for a non-exhaustive list). They have been doing this ever since the first commercial insurance policies became available in the seventeenth century. The transfer of risk from banks to the insurance market (both direct insurers and re-insurers) is therefore a major fact of commercial life and not something which has risen to prominence with the advent of an operational risk capital charge under Basel II. At the present time, the range of covers purchased and the range of insurers providing cover, coupled with the reinsurance they themselves purchase, probably argues against unwarranted concentration – other than amongst re-insurers, which are relatively few. In any case, the efficient management of insurance companies itself depends on a spread of risks by both policyholder and class of business and the management of aggregation, which again works against undue concentration of risk.

7. There is a suggestion that insurers devising policies to satisfy the perceived operational risk requirements of AMA banks are extending the coverage offered. Whilst that may be a neat solution from a bank's point of view I would hope that insurers and their regulators would treat extension of coverage with caution.

8. The final sentence of the section suggests that it is a simple matter to assess the capital accounted for by the particular segment of operational risk being insured and comparing this with the capital being assessed by the insurer. There are a number of problems with this, especially in respect of AMA banks. These include two fundamental issues:

- the risk may be transferred to a number of insurers, either by insurance layer or through co-insurance
- the basis for calibrating capital for the bank and the insurer or insurers involved will be different by virtue of:
 - the different methodologies used by banks and insurers to calibrate capital requirements for operational risk on the one hand and underwriting risk on the other

- the different confidence requirements – 99.9% for AMA banks and 99.5%, for example, for EU insurers under Solvency II.

4. Banking supervisors' assessment processes

9. The important point raised in the first paragraph of this section is the question of supervisory co-operation. Even in jurisdictions where banking and insurance is regulated by a single body, it seemed to me, when the pertinent paragraphs of Basel II were being written and interpreted, that there was little dialogue between banking and insurance colleagues, especially having regard to the encouragement given to insurers to devise multi-year policies, which had been a cause of significant losses to the insurance industry in the late 1990's. I therefore wholeheartedly endorse the proposals made in the second paragraph of section 4 and in particular the need for better communication between banking and insurance supervisors, so that bank requests for capital mitigation are expertly assessed.

10. That communication should also ensure that AMA requirements do not encourage insurers and the banks' insurance brokers to devise policies which are overly innovative, lacking in historical experience and therefore even more difficult to price appropriately than traditional policies.

11. Related to the question of increased communication between banking and insurance supervisors, I trust that responses to this paper, which has been written by banking supervisors within the context of the Basel supervisory framework, will be shared and debated with insurance colleagues. My own response is certainly written with the intention that it should be read by both audiences.

12. As regards paragraph 3 of section 4, it is undoubtedly true that the onus is on applicant banks to justify the mitigation they are seeking. Experts from the insurance industry can assist supervisors in challenging assumptions made by the applicant banks, but I would not expect their role to go beyond that and into the realms of second-guessing banks' assessments.

13. The final paragraph of the section seems to point to a conflict in supervisors' practices. Surely it should be a given that banks must 'robustly demonstrate the extent to which its insurance portfolio mitigates its operational risk exposure'. In addition, it is surprising to read that the collection and review of policy contracts for the relatively few banks accepted for AMA could be an undue burden for supervisors. Whilst supervisors will primarily rely on the assessments and explanations provided by banks, they should have the resources both in quantity and expertise to review policy contracts.

4.2 Experience requirement

14. Given the AMA 99.9% capital requirement, it is more than likely that few if any banks could acquire sufficient experience of even moderately 'tail' events to satisfy supervisors. One way of achieving some degree of experience would be to benchmark individual banks against external database information and the insurance

industry's own data. However, this is fraught by the considerations outlined in the example given in Appendix C Case 5. It is equally difficult to understand how long, in the context of the 99.9% capital assessment requirement, a parallel run would need to be. The recent LDCE clearly demonstrated that the overwhelming majority, certainly by number, of operational risk losses are well below the deductibles of most insurance policies. Large claims are, by their nature, infrequent and unlikely, even if by chance they occur, to point clearly to the inadequacy of the mitigation being claimed.

4.3 Approval of insurance contracts

15. I fully support the approach outlined in the second paragraph. The purpose of the AMA mitigation is to reflect the 'use test' of insurance within a bank's operational risk management process and not to reflect particular contract wordings, terms and conditions which, in any case, are rarely if ever completely standard across policyholders.

4.4 Reliance on AMA approval

16. AMA approval should reflect the quality of process within a bank. I therefore strongly endorse the paper's recommendation that insurers and brokers should perform independent reviews of the AMA of prospective insureds. I have been arguing for this for some years and hope that the recommendation will be followed through, not only by underwriters and brokers, but by the banks themselves in being transparent about their operational risk profiles and assessments, information which they have often been reluctant to divulge on the alleged grounds of market sensitivity. Contracts of insurance, in English law, are entered into *uberrimae fidei* – in the utmost good faith. This points to the greatest possible transparency at the outset of the contract and during its term.

7 Traditional and proposed insurance policies

Mapping

17. Just as one cause can lead to a variety of operational losses, and an operational loss can be triggered by a number of causes, so an insurance policy can cover a number of operational loss categories and an operational loss can be covered by a variety of policies – depending on the cause of the loss. I welcome the paper's recognition of the overlaps and underlaps of coverage in section 7 of the paper and am disappointed that in section 8.5 the paper nevertheless seems to assume that there is a direct mapping of a loss event category to a single policy or policy class.

18. Because of the limited ability to map operational loss categories directly to specific policy classes, I have always believed that the most effective way to assess the value of coverage of an insurance programme is to use scenario analysis. Unfortunately, scenarios are only mentioned in the paper in the context of a rather

unsatisfactory example in Appendix C Case 6. They are increasingly being used by banks for both their operational risk and insurance assessments and deserved much more extensive consideration in the paper. I trust that will be a priority for the Committee in its future deliberations.

AMA compliant policies

19. Members of SIGOR may recall that it has long been a concern of mine that, in order to 'comply' with AMA requirements, insurers are being encouraged to amend policy wordings which have been tried and tested in the Courts over very many years. In part this stems from banks' lack of understanding of how insurance works, which is reinforced by the critical role of brokers acting as intermediaries on behalf of their clients, the banks, rather than the insurance industry.

20. The paper talks of a hybrid 'overlay' policy, or a 'basket' operational risk policy, presumably akin to the FIORI product developed by Swiss Re, which was widely believed to have resulted in considerable losses. I completely support the caution of supervisors, on the part of both banking and insurance supervisors, I assume, regarding policies which attempt to extend coverage considerably in this way.

21. Extending coverage does not increase diversification, as appears to be suggested in paragraph 3 of section 7, but can add to insurers' overall exposure. Diversification is achieved by increasing the number of insureds buying a particular class of policy or by spreading existing exposure across classes. A basket policy would simply increase overall exposure. I fully support the comments made in Footnote 6.

22. The trick for the insurance industry is to devise products which as far as possible maintain current coverage and wordings but which nevertheless comply with the AMA requirements. The largest single problem to overcome is the haircut for policies with a residual term of less than one year and, as the paper points out, this has resulted in a degree of 'innovation' in offering 'longer term policies for operational risks'. These are not so much innovative, as a return to the multi-year policies available in the softer markets of the late 1990's which resulted in significant losses. I therefore again support the caution expressed in the paper.

23. Members of the Committee may recall one or other of my presentations to supervisors and the industry in which I proposed an 'overlay' policy which merely sought to deal with the AMA qualifying criteria and which did not affect the terms of the underlying policies as regards coverage, deductibles or limits. The question of maintaining the 12 month term was covered by a clause in which this was implicit when the policy was originally drawn up through the concept of extended discovery. If, however, the insured chose to cancel the policy after the first 12 months, it would pay not a penal premium as such, but a premium which reflected the run-off of that particular year of cover.

24. Another proposal has been the 'evergreen' policy, in imitation of bank revolving credits. The arrangement I have suggested in the previous paragraph, by maintaining years of cover, rather than attempting to establish an 'evergreen' policy, would also satisfy the annual venture nature of, for example, the Lloyd's market.

25. I believe that because of their own interests and work on the subject, this type of 'overlay' policy was not taken up by brokers or reinsurers. I remain of the view, however, that it would be a beneficial and equitable solution for banks, insurers and their respective supervisors and I urge supervisors to reconsider it.

8.1 Claims paying ability

26. The Basel text referred to claims paying ability. As I have remarked in previous representations to the Committee and their colleagues, the credit ratings given to insurers relate to 'financial strength' rather than claims paying ability. It would have been helpful if this could have been explained in the paper.

27. It is also disappointing that Appendix A merely copies from the Accord and does not refer to A.M. Best, which is the leading specialist rating agency for insurance, became the fifth NSRO in the US in 2005 and has a very different set of ratings from those quoted. I have no commercial or personal interest in A.M. Best, but their absence from the paper, at this stage of the debate on insurance for operational risk is in my view an unfortunate omission.

8.2.1 Renewable and equivalent cover

28. Whilst it is true that emerging risks, such as terrorism, can be, and often are, excluded from relevant policy classes following a major incident, it is generally the case that the industry then devises policies specifically worded to cover the new peril. This has happened in the case of terrorism and indeed cyber terrorism and reflects the fact that existing wording and pricing is rendered obsolete. It is true that banks should be alive to this issue, but I question how significant it is in the overall context of operational risk and the AMA.

29. The last paragraph of this section states that banks should calculate capital gross and net of insurance which is not unreasonable. It then appears to assume that a particular policy will have a specific amount of capital mitigation attributed to it and that the exercise can be undertaken on a policy by policy basis. This appears to perpetuate an idea that in some way an insurance policy has an intrinsic value. In line with the views I have expressed above at paragraphs 8, 17 and 18 I suspect that, in the case of policy classes which cover a number of operational loss event categories, and in the context of the overall insurance programme purchased by a bank, it will be difficult to achieve the granularity suggested in the paper.

8.2.2 Claims bases

30. A number of classes, such as Computer Crime and Unauthorised Trading, are, in fact, 'discovery-based' (see Annex A). It would have been helpful if the paper had specifically referred in addition to this basis for claims.

John Thirlwell

28 January 2010

ANNEX A – EXAMPLES OF POLICIES AVAILABLE TO BANKS AND THE BASIS OF COVER

Policy coverage	Type of Cover
1. Bankers' Blanket Bond	Losses discovered
2. Business Interruption Policy	Losses occurring
3. Computer Crime Policy	Losses discovered
4. Commercial General Liability Policy	Claims made
5. Credit Card Policy	Losses discovered
6. Directors & Officers Liability Policy (Corporate Reimbursement only)	Claims made
7. Employment Practices Liability Policy	Claims made
8. Key Man Policy	Losses occurring
9. Kidnap and Ransom Policy	Losses occurring
10. Property Insurance Policy	Losses occurring
11. Professional Indemnity [Civil Liability] Policy	Claims made
12. Unauthorised Trading Policy	Losses discovered
13. Terrorism Policy	Losses occurring
14. Pension Trustee Liability Policy	Claims made
15. Registrars Liability Policy	Claims made