

Insurance and operational risk under CRD

John Thirlwell

CEBS NOVI-O, London, 29 January 2008

Agenda

- CRD criteria
 - specifics
 - mapping
- Solutions
 - Comments on some market solutions
 - A preferred solution

CV - Insurance and operational risk

- Banking – Barclays, LloydsTSB, Hill Samuel (Head of Risk; Chairman, Credit Committee)
- 1996 – 2003 Director, Risk and Regulation, British Bankers' Association
 - Chairman, BBA Global Operational Loss Database (2001-03)
 - BBA surveys of op risk management practices 1997 and 1999 (with ISDA, RMA – Operational Risk: The Last frontier)
 - Presentation to Basel Committee RMG (pp EBF) on insurance and op risk
- 2003- Non-executive Director, Novae Syndicates Ltd (leading Lloyd's FI underwriter)
- 2004- Non-executive Director, Chase Cooper International Ltd (op risk consultancy and aCCelerate op risk software)
- 2003- Adviser (on banking regulatory matters), Talbot Underwriting Ltd (Lloyd's FI underwriter)
- 2007- Non-executive Director, CX Re Ltd (formerly CNA (UK))
- Publications
 - Insurance and operational risk, *The Basel Handbook*, Risk Books, 2004 & 2007
 - Regular column in *Operational Risk and Compliance* magazine (2003-5)
- Conferences – frequent speaker and chairman (including chairing OpRisk Europe and OpRisk USA)
- Fuller details on all the above at www.johnthirlwell.co.uk

Agenda

- **CRD criteria**
 - **specifics**
 - mapping
- **Solutions**
 - Comments on some market solutions
 - A preferred solution

CRD Qualifying Criteria

- *Minimum claims paying ability* rating of A [(or equivalent)]
- Initial policy term must be no less than 12 months
- *“Haircut” to be applied to a residual term of less than 12 months* down to a full 100% haircut (i.e. nil value) for residual term of less than 90 days
- Minimum notice period for cancellation and/or non-renewal of 90 days
- No exclusions for:
 - Supervisory/regulatory actions
 - Appointment of receiver or liquidator (except for events occurring after initiation of receivership or liquidation)
- Insurance must be arranged through third parties. If captives are used exposure must be laid off through independent third parties i.e. reinsurers
- Risk mitigation to reflect bank’s insurance *coverage* consistent with overall operational risk capital calibration
- Mitigation limited to 20% of bank’s operational risk capital charge

A.M. BEST	
Secure	Vulnerable
A++, A+ Superior	B, B - Fair
A, A - Excellent	C++, C+ Marginal
B++, B+ Very good	C, C - Weak
	D Poor
	E Under regulatory supervision
	F In liquidation
	S Rating suspended

STANDARD & POOR'S	
“Able to meet financial commitments”	Vulnerable
AAA Extremely strong	BB Marginal
AA Very strong	B Weak
A Strong	CCC Very weak
BBB Good	CC Extremely weak
	R Regulatory action

Agenda

- **CRD criteria**
 - specifics
 - **mapping**
- **Solutions**
 - Comments on some market solutions
 - A preferred solution

Financial Institutions' "Traditional" Portfolio of Policies

- Bankers' Blanket Bond
- Electronic Computer Crime Policy
- Property Insurance Policy
- Unauthorised Trading Policy
- Business Interruption Policy
- Key Man Policy
- Kidnap & Ransom Policy
- Terrorism Policy
- Commercial General Liability Policy
- Directors' & Officers' (D&O) Liability Policy
- Employment Practices Liability Policy
- Professional Indemnity (PI) Policy
- Pension Trustee Liability Policy
- Registrars Liability Policy

Risk mapping

Category (Level 1)	Sub-category (Level 2)	Sub-category (Level 3)	Explanation / Example	Insurance Type and comment
People	Employee Fraud/Malice	Collusion	Involves more than one person, at least one of whom is an employee	BBB, ECC (if computer-related) Must be manifest intent to cause loss, or to receive gain Malicious acts not covered unless employee dishonest / fraudulent act
		Embezzlement	Obtaining money by deception; employee effectively steals from a client/customer e.g. raising false loans, altering cheques	BBB, ECC (if computer-related) Must be manifest intent to cause loss, or to receive gain
		(Deliberate) sabotage (including of a bank's reputation)		BBB, ECC (if computer-related) Must be tangible, provable damage
		(Deliberate) money laundering		<i>Standard exclusion across all coverage sections</i>
		Theft - physical	e.g. computer equipment, cash, artwork	BBB – <i>Tangible assets only</i>
		Theft - intellectual property	e.g. deliberate theft of software	FG – not covered under definition of property. PI- possible if legal liability to 3 rd party
		Programming fraud	e.g. deliberate introduction of a computer virus, by an employee	ECC - <i>loss of Data caused by any party; normal to have inner limit</i>

Category (Level 1)	Sub-category (Level 2)	Sub-category (Level 3)	Explanation / Example	Insurance Type and comment
People	Unauthorised Activity/ "Rogue" Trading/ Employee Misdeed	Misuse of privileged information	e.g. insider trading, front running	UT – not covered PI – covered if legal liability to 3 rd party
		Churning	Falsely inflating a deal for commission purposes	UT – not covered PI – standard exclusion
		Market manipulation	False/misleading statements; price manipulation	PI – covered if legal liability to 3 rd party
		Activity leading to deliberate mis-pricing	Unauthorised or other irregular activity which affects internal portfolio pricing	UT – not covered PI possible if 3 rd party who the insured has a legal relationship with suffers a loss
		Activity with unauthorised counterparty		UT – covered subject to there being a deliberate act and deliberate concealment
		Activity in unauthorised product		
		Limit breach	Deliberate breach by employee	
		Incorrect models (intentional)	Deliberately manipulating model; unauthorised changes to parameters	UT – not covered
		Activity outside exchange rules		UT – not covered PI – possible if civil liability coverage is provided
		Illegal/aggressive selling tactics	Deliberately or negligently selling inappropriate product or dispensing incorrect advice	UT – not covered PI – Covered if legal liability at law
		Ignoring/short-circuiting procedures (deliberate) Other		UT – not covered

Category (Level 1)	Sub-category (Level 2)	Sub-category (Level 3)	Explanation / Example	Insurance Type and comment
People	Employment law	Wrongful termination		EPL – covered EPL – covered EPL – covered
		Discrimination/equal opportunity		EPL – only covered if results in claim from insuring clauses PI – Possible if civil liability coverage is provided
		Harassment		No
		Non-adherence to other Employment law		EPL
		Non-adherence to Health and Safety Regulations		No
		Other	<i>Retaliation Claims</i>	
	Workforce disruption	Industrial action	By firm's employees	No
	Loss or lack of key personnel	Lack of suitable employees	Suitable employees not available internally or in market place when needed	No
		Loss of key personnel Other	This may result in a loss of clients/business or the loss of a product line	PA policy o Could be modification of "Key Person"

Risk Events and Insurance Mapping

- Because insurance looks to cause, a particular risk event under Basel II/CRD may be covered by more than one class of policy e.g.
 - A fire can give rise to property damage (property policy) and loss of documents (Bankers' Blanket Bond)
 - Employee infidelity can result in losses/claims under a Bankers' Blanket Bond and a Professional Indemnity Policy incorporating a dishonesty extension
 - Subprime credit squeeze - Investment banks exposed to claims under their Professional Indemnity/Civil Liability Policies and D&O Policies
- As with operational risk: a single risk event can be the result of a number of causes; a single cause can result in a number of event outcomes

LDCE: Insurance as a loss mitigator

Prevalence of Recovery Type

Table 17
Prevalence of Recovery Type
Sample 1 (89 Banks)

Business Line	Percentage of Total Recoveries Resulting from 'Other' Recoveries	Percentage of Total Recoveries Resulting from Non-Zero Insurance Recoveries
Corporate Finance	89.6%	10.4%
Trading & Sales	91.8%	9.1%
Retail Banking	87.7%	12.8%
Commercial Banking	89.7%	10.6%
Payment & Settlement	79.8%	22.0%
Agency Services	77.5%	23.6%
Asset Management	88.3%	11.7%
Retail Brokerage	96.9%	3.1%
All Business Lines	88.7%	11.8%

Event Type	Percentage of Total Recoveries Resulting from 'Other' Recoveries	Percentage of Total Recoveries Resulting from Non-Zero Insurance Recoveries
Internal Fraud	86.0%	16.7%
External Fraud	92.0%	8.5%
Employment Practices & Workplace Safety	25.4%	74.6%
Clients, Products & Business Practices	90.5%	9.8%
Damage to Physical Assets	9.4%	91.1%
Business Disruptions & System Failures	49.1%	50.9%
Execution, Delivery & Process Management	96.1%	4.0%
All Event Types	88.7%	11.8%

Note: Total Recoveries is equal to non-zero insurance recoveries and 'other' recoveries

Note: Because 30 events have recoveries of both types, the sum of the percentages in the two columns can sum to greater than 100%.

LDCE: insurance recovery rates

Table 19
Recovery Rates by Gross Loss Amount

Panel A: Sample 1 (89 Banks)				
Gross Loss Amount (Euros 1000s)	Recovery Amount as a % of Loss Amount for all Insurance Claims (Includes Zero Recoveries)	Recovery Amount as a % of Loss Amount for all Insurance Claims (Excludes Zero Recoveries)	Non-Insurance Recovery Amount as a % of Loss Amount	Total Recovery Amount, Including Insurance and 'Other' Recoveries, as % of Loss Amount
0-10	79.4%	82.7%	83.3%	83.2%
10-50	58.2%	75.3%	57.0%	58.8%
50-100	57.7%	73.0%	56.2%	58.8%
100-500	62.7%	73.7%	61.2%	64.0%
500-1000	46.7%	52.9%	58.6%	66.2%
Greater than 1000	54.0%	66.0%	65.1%	67.6%
All Loss Events	58.4%	73.3%	58.6%	60.6%

Panel B: Sample 2 (63 Banks)				
Gross Loss Amount (Euros 1000s)	Recovery Amount as a % of Loss Amount for all Insurance Claims (Includes Zero Recoveries)	Recovery Amount as a % of Loss Amount for all Insurance Claims (Excludes Zero Recoveries)	Non-Insurance Recovery Amount as a % of Loss Amount	Total Recovery Amount, Including Insurance and 'Other' Recoveries, as % of Loss Amount
10-50	57.6%	72.3%	58.4%	59.2%
50-100	52.5%	67.6%	56.8%	58.2%
100-500	57.3%	72.0%	60.8%	62.8%
500-1000	42.0%	49.1%	59.1%	66.6%
Greater than 1000	41.0%	54.3%	71.4%	68.9%
All Loss Events	54.6%	68.8%	58.7%	59.7%

Policy Triggers

- Coverage is triggered by different events under different policies
- Discovery based – loss occurs before or within the policy period and is discovered during the policy period e.g. Bankers Blanket Bond Policy
- Occurrence based – loss occurs when the injury occurs and not when, for example, the negligent act takes place or the discovery of the injury e.g. Property Policy
- Claims made – For claims and notification of claims made during the period of cover, even though the event giving rise to the claim occurred earlier e.g. Professional Indemnity Policy

Agenda

- CRD criteria
 - specifics
 - mapping
- **Solutions**
 - **Comments on some market solutions**
 - A preferred solution

Comments on some market solutions

- Coverage
 - re-writing policies to ‘fit’ Basel (Level 1) criteria
 - Professional Indemnity (PI) and crime
 - Bankers’ Blanket Bond and PI only being considered
- Term
 - 2 year policies, with 1 year break
 - 12 month ‘evergreen’ policies
- Pricing (rating) and capital assessment issues for insurers

Agenda

- CRD criteria
 - specifics
 - mapping
- **Solutions**
 - Comments on some market solutions
 - **A preferred solution**

'Talbot' Solution – a modest proposal

- Talbot's solution is to offer an over-riding condition, by way of an endorsement, which incorporates the principal Basel II/CRD qualifying criteria, whilst preserving the traditional portfolio of policies available to financial institutions in the London market
- No unnecessary expansion in cover/rewriting policies and therefore no loading of underwriters' ICA
- Simple solution whereby overriding conditions are imposed on the underlying policies

Principal Features of the Overriding Conditions

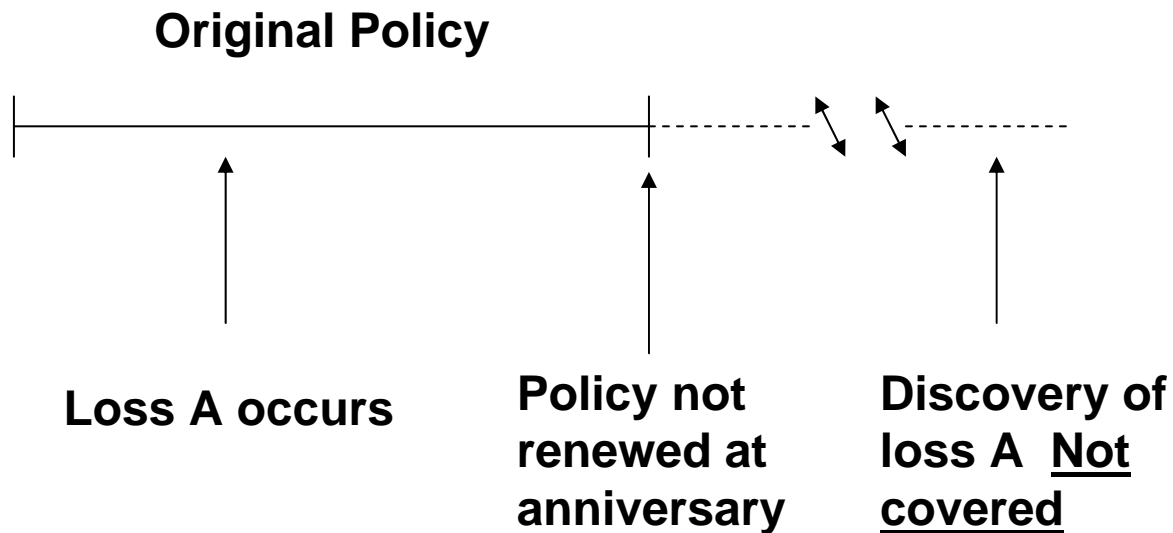
- Minimum 90 day cancellation period
- 12 month discovery extension period – mandatory in the event of non-renewal
- Replacement of insurer whose rating falls below the qualifying threshold
- Fast track dispute resolution procedure

Policy Triggers

- Coverage is triggered by different events under different policies
- Discovery based – loss occurs before or within the policy period and is discovered during the policy period e.g. Bankers' Blanket Bond Policy
- Occurrence based – loss occurs when the injury occurs and not when, for example, the negligent act takes place or the discovery of the injury e.g. Property Policy
- Claims made – For claims and notification of claims made during the period of cover, even though the event giving rise to the claim occurred earlier e.g. Professional Indemnity Policy

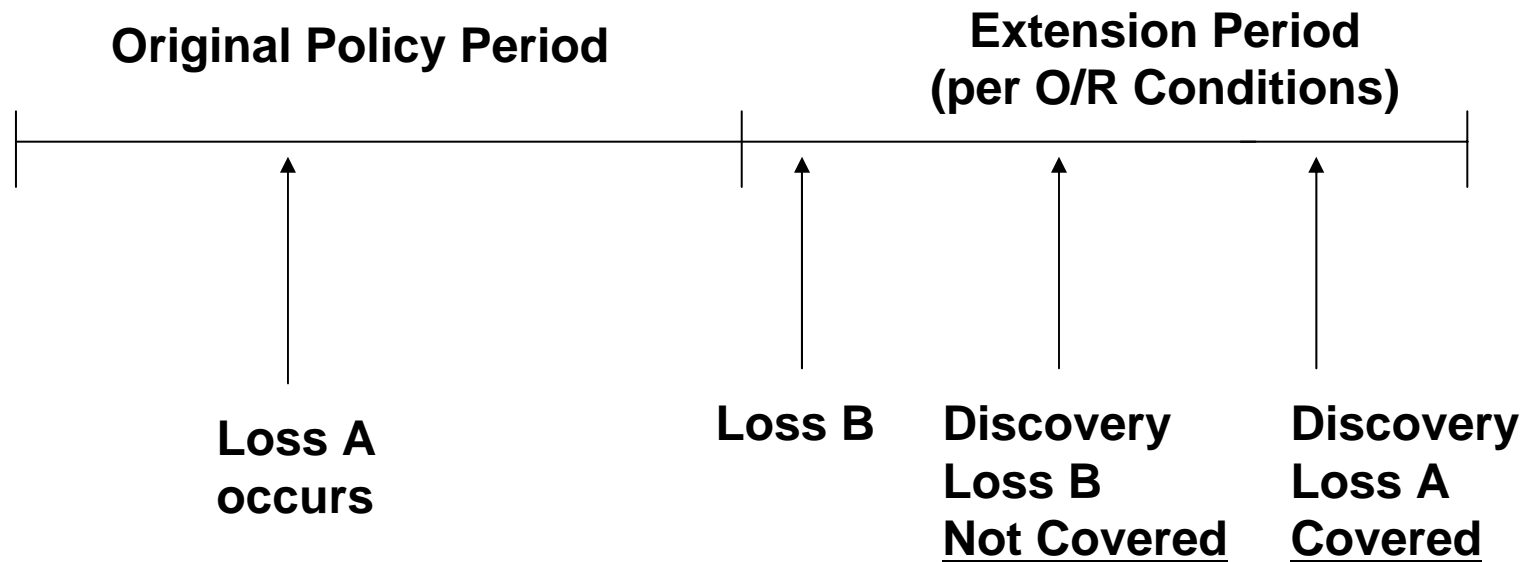
Underlying Discovery Based Policies - Pre Basel II – current position

- E.g. Bankers' Blanket Bond
- Original 12 month policy-non-renewed



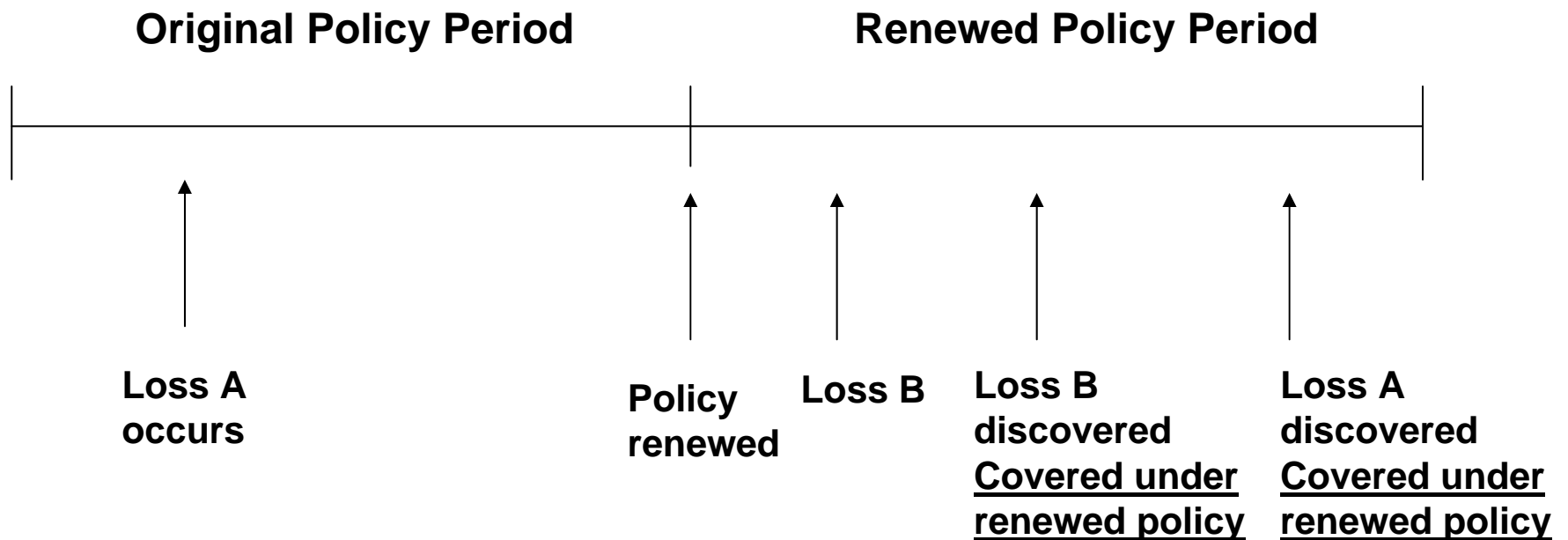
Underlying Discovery Based Policies - with Basel II solution applied

- Loss takes place during or before the Original Policy and is discovered in the Extension Period



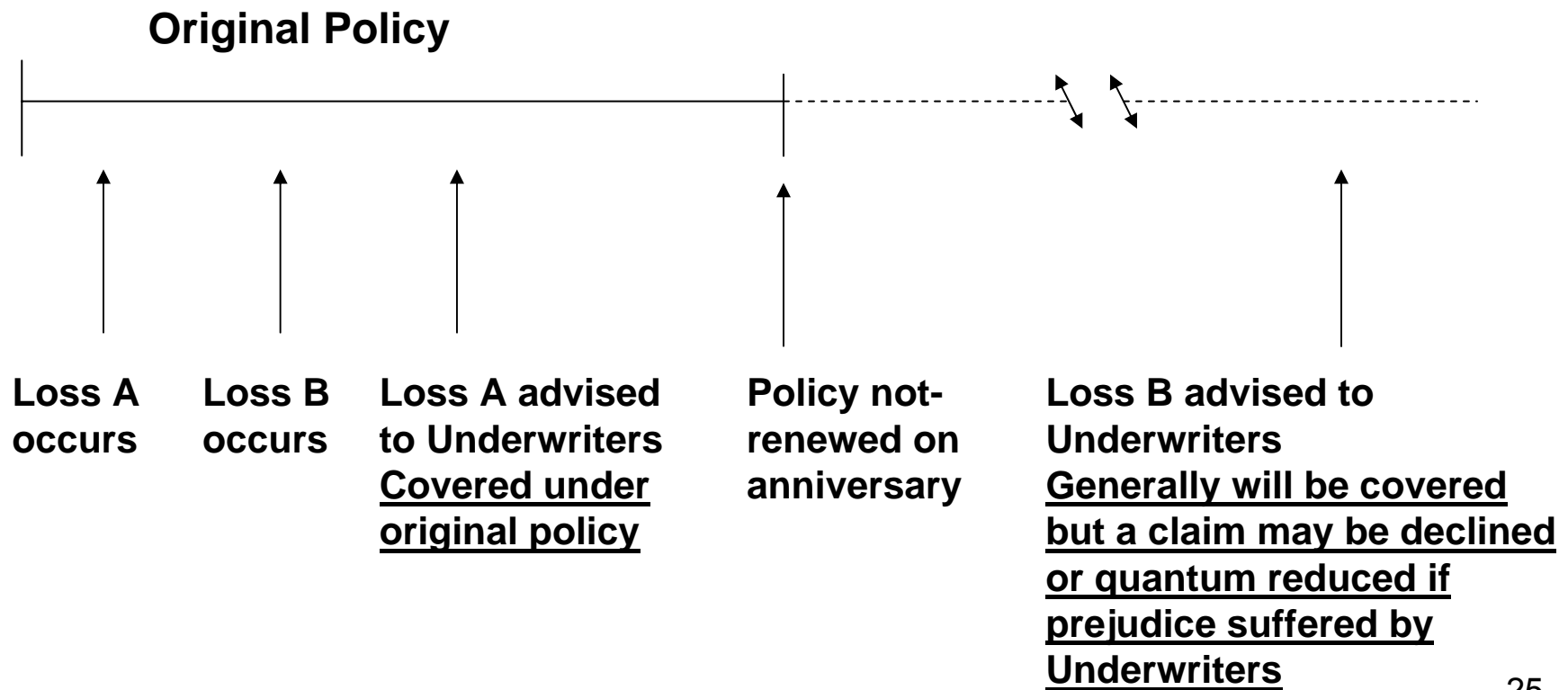
Underlying Discovery Based Policies – Renewed Policy

- Original Policy renewed on first anniversary
- The new policy supersedes the extension period granted. An appropriate adjustment is made to the renewal premium to reflect this.



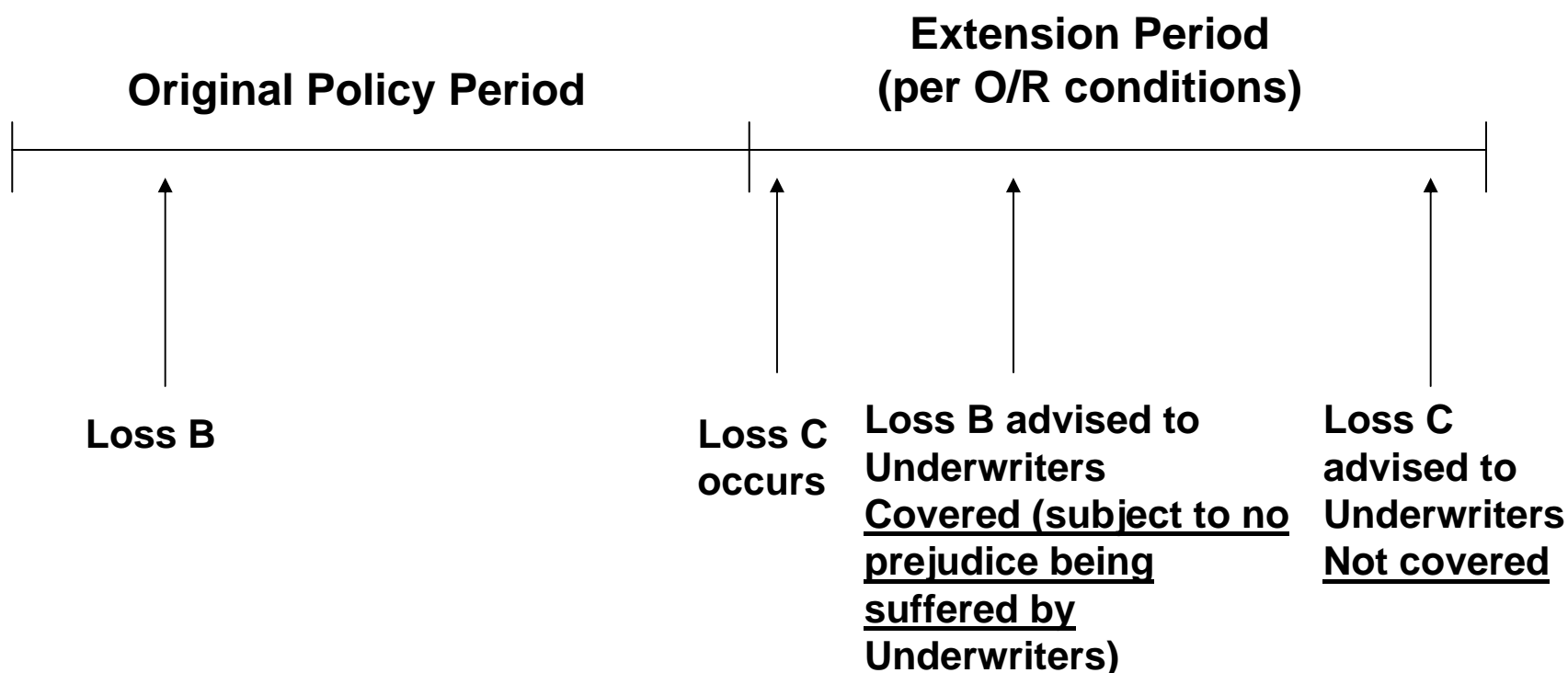
Underlying Loss Occurring Policies - Pre Basel II - Current position

- Original Policy not renewed
- E.g. Property Policy



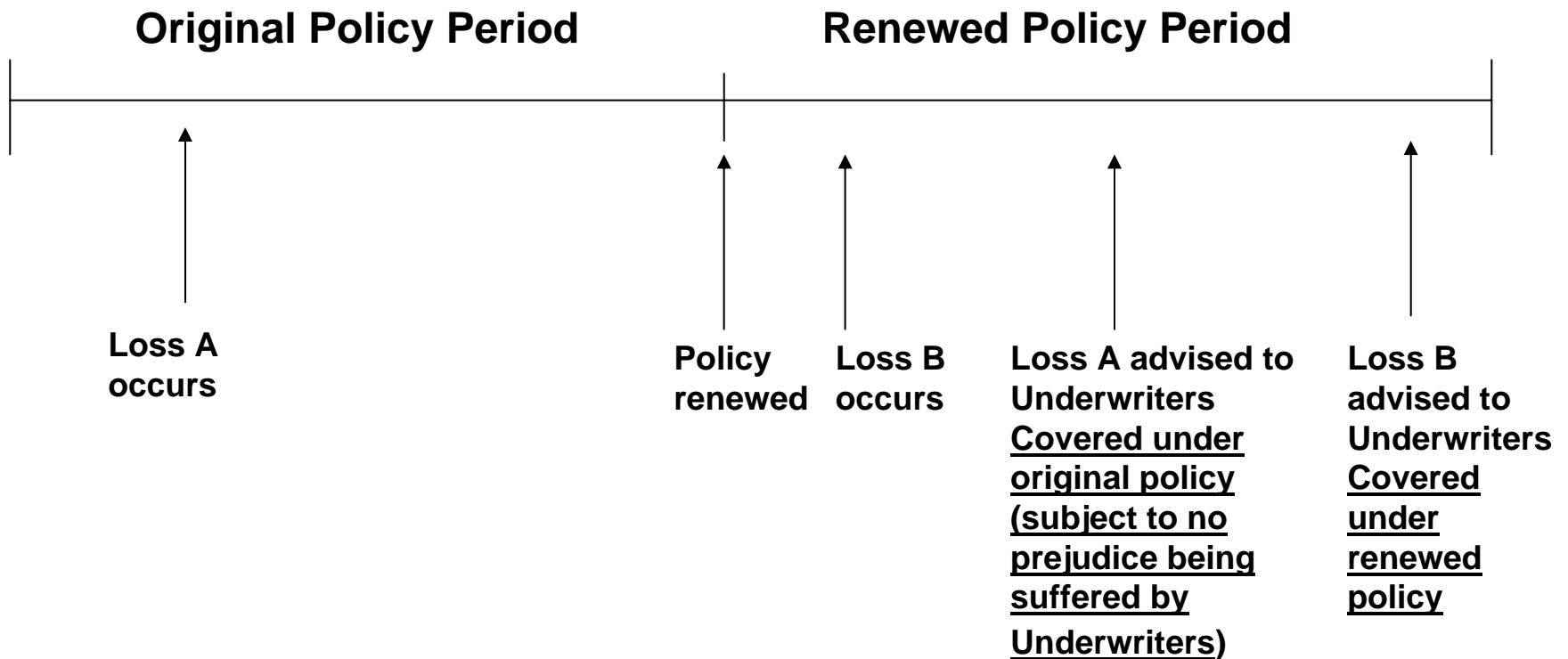
Underlying Loss Occurring Policies - with Basel II solution applied

- Loss takes place in the Original Policy and claim made in the Extension Period



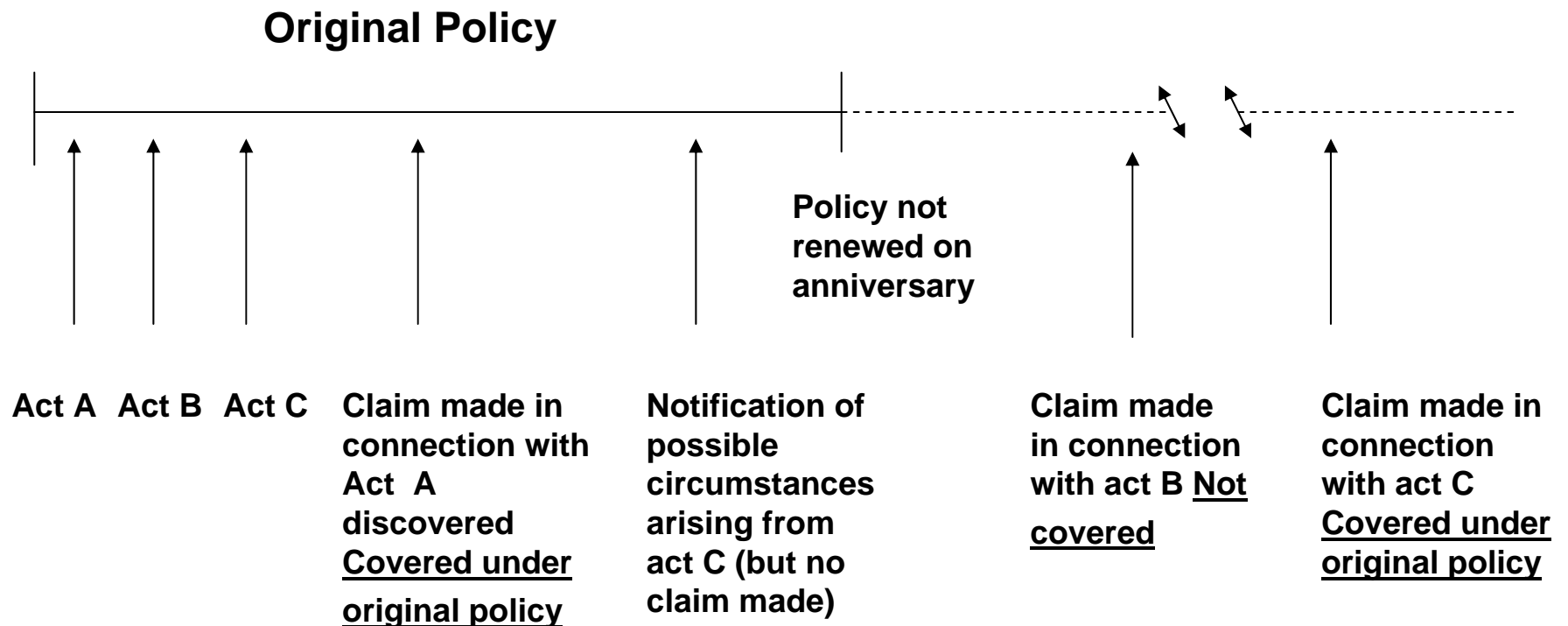
Underlying Loss Occurring Policies – Renewed Policy

- Original Policy renewed on first anniversary



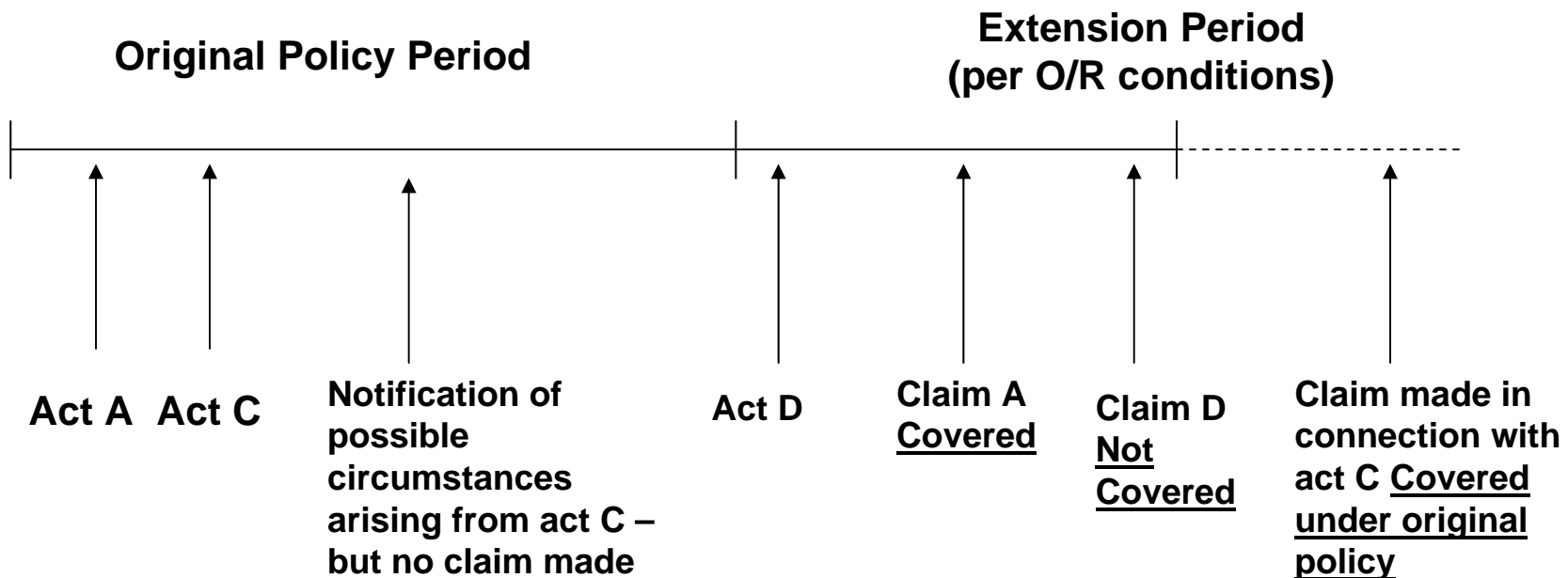
Underlying Claims Made Policies - Pre Basel II - Current Position

- Original policy not renewed
- E.g. Professional Indemnity



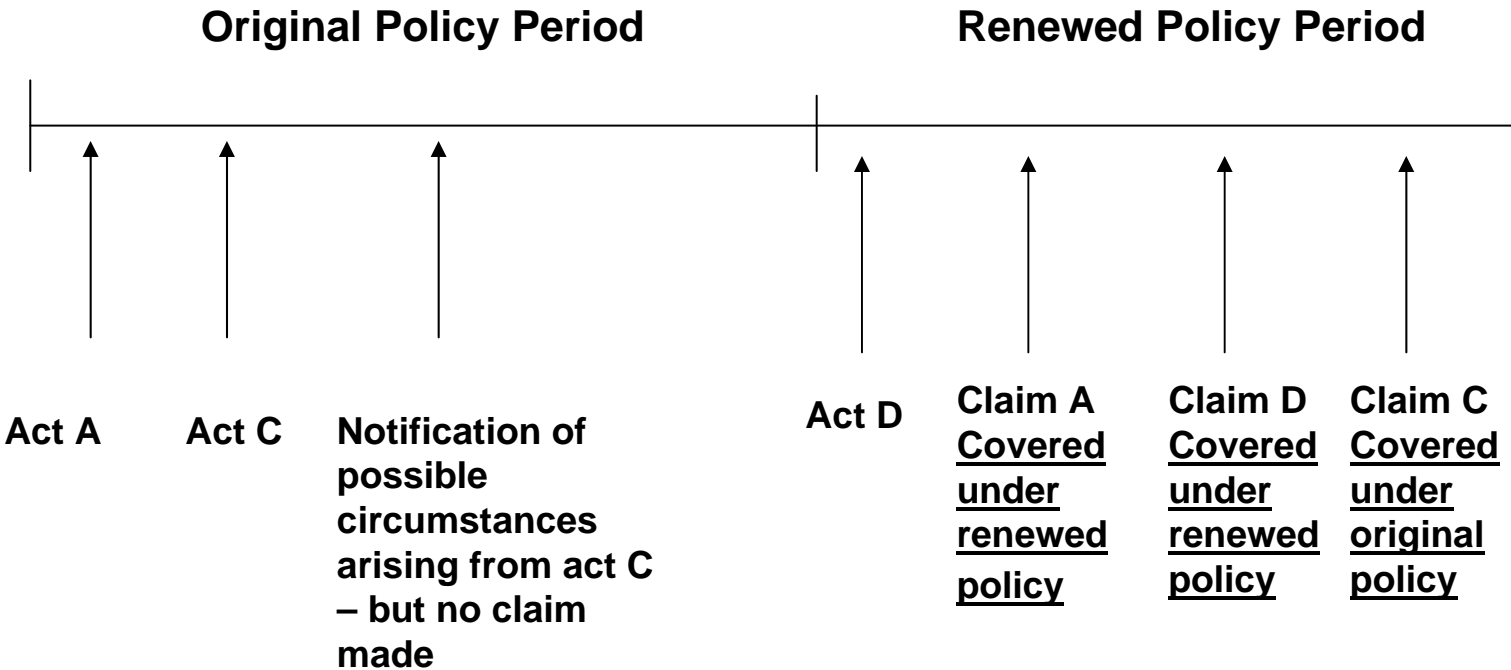
Underlying Claims Made Policies – with Basel II solution applied

- Act or omission occurred within or before the Underlying Insurance Period
- Falls within the terms of the Underlying Insurance Policy
- Not previously notified under a preceding policy



Underlying Claims Made Policies – Renewed Policy

- Original policy renewed on first anniversary



In Summary:

- Talbot believe that they have devised a simple product which addresses Basel II/CRD criteria
- Tried and tested underlying insurance policies remain undisturbed thus maintaining contract certainty for purchasers
- No unnecessary extension or re-casting of insurance coverage, which would lead to legal uncertainty and probably increased capital requirements

John Thirlwell

Tel: +44 (0)20 8386 8019

E-mail: info@johnthirlwell.co.uk