Exploding the myths – Insurance under Basel II and the CRD

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Agenda

- **Basel basics**
- CRD criteria
  - specifics
  - ‘mapping’
- Comments on some market solutions
  - Coverage

A short history of Basel II

1988 –First Capital Accord published by the Basel Committee for Banking Supervision of the Bank for International Settlements (Basel I)

A crude attempt to raise the overall level of global bank capital following the oil shocks and LDC crisis of the 70s and early 80s.

Capital = 8% x risk weighted assets (minimum)

2004 (June) – Basel II published. Its principal purposes:

- Make capital for *credit* risk more aligned to actual risk
- Introduce capital for *operational* risk

Market risk had been dealt with separately in 1996

Liquidity risk not specifically covered

The 3 Pillars of Basel II

- Pillar 1 – minimum regulatory capital calculation (FSA ICAAP/ICAS)
- Pillar 2 – supervisory review (FSA ARROW)
- Pillar 3 – market disclosure

The 3 approaches of Pillar 1

Credit risk	**Operational risk**
Standardised	Basic
Internal Ratings Based (Foundation) [FIRB]	Standardised [TSA]
Internal Ratings Based (Advanced) [AIRB]	Advanced Measurement Approach [AMA]

Pillar 1 capital for operational risk

Basic Approach: Gross income x 15%

Standardised Approach: Gross income of each of 8 business lines x β (%)

Advanced Measurement Approach – banks assess their own capital, based on their own preferred methodology.

Standardised Approach - Business Lines and betas (%)

Corporate finance	18
Trading and sales	18
Retail banking	12
Commercial banking	15
Payment and settlement	18
Agency services	15
Asset management	12
Retail brokerage	12
[Investment firms	9/11 – CRD only]

Implementation – EU and US

Becoming law

Basel I and II are ‘gentlemen’s agreements’.

In the EU Basel II became law through the Capital Requirements Directive (June 2006).

In the UK it became law through the FSA Handbook, under its authority through the Financial Services and Markets Act 2000.

In the US it became law under Notices of Rulemaking issued by the various regulators: Federal Reserve banks, Comptroller of the Currency and FDIC.

Timing

- EU
  - All credit institutions, including investment banks.
  - Basic and Standardised Approaches: 1.1.07;
  - Advanced Approach: 1.1.08 (in line with Basel II text)

- US
  - 10 largest banks (+ volunteers = 15/20?) *must* be on Advanced approaches: 1.1.09
  - Others remain on Basel I, with option of ‘Basel Ia’ (mortgages; retail portfolios etc)
  - Investment banks regulated by SEC, which will bring in similar rules to Basel.
  - Capital floors for 3 years (95%, 90%, 85%)

Implementation around the world

Date	Country	Scope
By 1.1.08	Australia	All banks, all approaches
	Canada	All banks, all approaches
	Hong Kong	All banks, all approaches (with floors to 1.1.10)
	Singapore	All banks, all approaches
	South Africa	All banks, all approaches
	Japan	All banks, non-advanced approaches
	Chile	All banks. Advanced approaches not being offered
1.4.08	India	Foreign banks, Indian banks with foreign branches, State Bank of India and ICICI – Standardised credit, Basic OR minimum.
	Japan	All banks, advanced approaches
1.4.09	India	All banks - Standardised credit, Basic OR
No implementation date	China, Malaysia, Philippines	Use Basel as a benchmark
2010?	Russia	All banks, Standardised Approach as a minimum

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  - **specifics**
  - ‘mapping’

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What does Basel/CRD actually say about insurance?

Insurer rating

- Minimum claims paying ability rating of A (or equivalent)

Policy term

- Initial policy term must be no less than 12 months

Minimum notice period

- Minimum notice period for cancellation and/or non-renewal of 90 days

The ‘haircut’

- “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

‘Mapping’

- Risk mitigation to reflect bank’s insurance *coverage* consistent with overall operational risk capital calibration

Cap

- 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

What Basel/CRD actually says - 2

Exclusions

- No exclusions:
  - Triggered by supervisory actions
  - Relating to the appointment of a receiver or liquidator (except for events occurring after initiation of receivership or liquidation)

Captives

- Insurance must be arranged through third parties. If captives are used, exposure must be laid off through independent third parties, e.g. presumably reinsurers

Payment

- Banks must allow for the time value of money re receipt of claims.

Coverage

- Capital mitigation through insurance is available for all classes of policy.

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Portfolio of traditional policies – financial institutions

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

Basel II Loss event categories

LEVEL 1	LEVEL 2
Internal Fraud	Unauthorised activity Theft and fraud
External fraud	Theft and fraud Systems security
Employment practices and workplace safety	Employee relations Safe environment Diversity and discrimination
Clients, products and business practices	Suitability, disclosure and fiduciary Improper business or market practices Product flaws Selection, sponsorship and exposure Advisory activities
Damage to physical assets	Disasters and other events
Business disruption and systems failures	Systems
Execution, delivery and process management	Transaction capture, execution and maintenance Monitoring and reporting Customer intake and documentation Customer/client account management Trade counterparties Vendors and suppliers

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		*Standard exclusion across all coverage sections*
		Theft - physical	e.g. computer equipment, cash, artwork	BBB – *Tangible assets only*
		Theft - intellectual property	e.g. deliberate theft of software	FG – not covered under definition of property. PI- possible if legal liability to 3rd party
		Programming fraud	e.g. deliberate introduction of a computer virus, by an employee	ECC - *loss of Data caused by any party; normal to have inner limit*

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 3rd 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 3rd party*
		Activity leading to deliberate mis-pricing	Unauthorised or other irregular activity which affects internal portfolio pricing	*UT – not covered* *PI possible if 3rd 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*

Insurance and operational risk

CAUSE ➔ EVENT ➔ EFFECT

CAUSE	EVENT	EFFECT
↓	↓	↓
Insurance	Op risk	Claim/loss

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)
  - An Internal fraud event could result in claims under a Bankers’ Blanket Bond, Electronic Computer Crime Policy, Professional Indemnity Policy or Directors’ & Officers’ Policy
  - 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
- Might scenarios be a better approach to ‘mapping’?

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Comments on some proposed solutions - coverage

- Re-writing policies to ‘fit’ Basel (Level 1) criteria
- “Policies must cover *all* loss events”
- Professional Indemnity (PI) (3^{rd} party) and crime (1^{st} party)
- Generally, only Bankers’ Blanket Bond and PI being considered

Issues

- Banks and bank regulators vs insurers
- Basel does not require any change to existing policies and wordings
- Contract certainty
- Pricing (rating)
- Capital assessment issues for insurers (and their regulators)

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