

Insurance and operational risk under Basel II and the CRD

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BBA, London, 14 May 2008

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:
 - Triggered by supervisory actions
 - Relating to the appointment of a 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, e.g. presumably 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

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Financial Institutions' "Traditional" Portfolio of Policies

- Bankers' Blanket Bond
- Business Interruption Policy
- Commercial General Liability Policy
- Computer Crime Policy
- Credit Card Policy
- Directors' & Officers' (D&O) Liability Policy
- Employment Practices Liability Policy
- Key Man Policy
- Kidnap & Ransom Policy
- Property Insurance Policy
- Professional Indemnity (PI) Policy
- Terrorism Policy
- Unauthorised Trading 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	Retaliation Claims	
	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"

Insurance and operational risk



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 the better answer?

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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) (3rd party) and crime (1st party)
 - Generally, only Bankers’ Blanket Bond and PI being considered
- Term
 - Multi-year policies, e.g.
 - 2 year policies,
 - 2 year policies with 1 year break
 - 12 month ‘evergreen’ policies
- Pricing (rating) and capital assessment issues for insurers (and their regulators)

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Policy types and 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
- Occurrence based – loss occurs when the injury occurs and not when, for example, the negligent act takes place or the discovery of the injury
- 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

Policy types

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

A possible solution

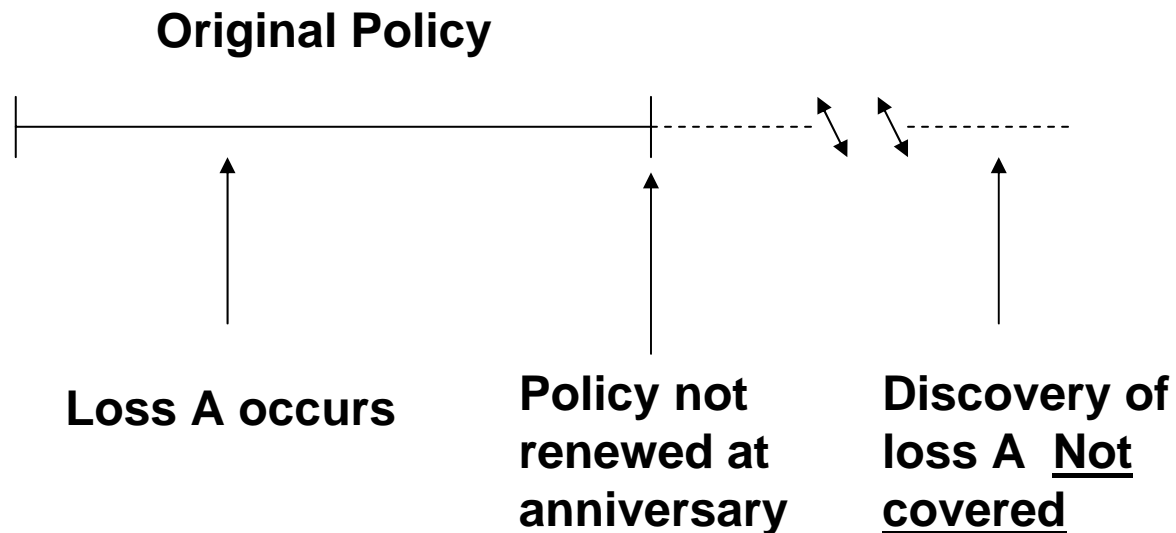
- The exposure to insurance coverage at or before 31 December under the existing 12 month policy/ies will be covered for at least 12 months
- The solution provides:
 - an over-riding condition, by way of an endorsement,
 - which incorporates the principal Basel II/CRD qualifying criteria,
 - and is imposed on the underlying policies.
- It thus preserves the traditional portfolio of policies available to financial institutions in the London market and the certainties of interpretation (and, for insurers, of capital assessment and pricing) which go with that.

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

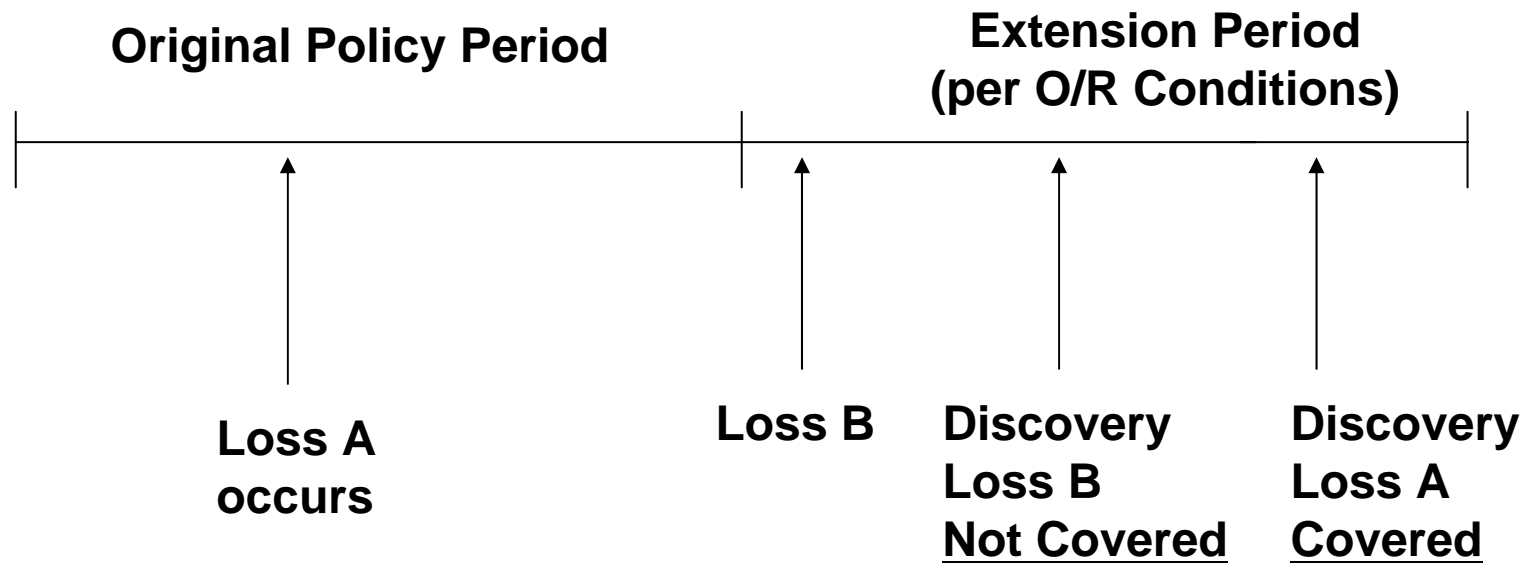
Underlying Discovery Based Policies - Pre Basel II – current position

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



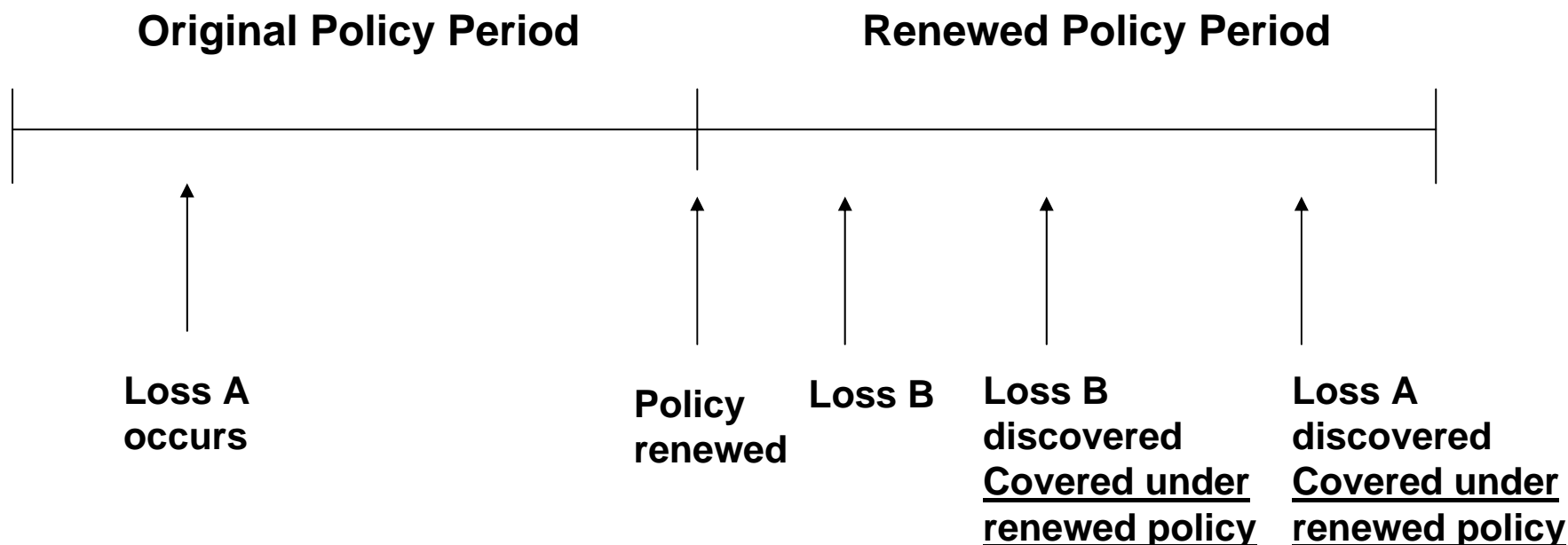
Underlying Discovery Based Policies - with Basel II solution applied

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



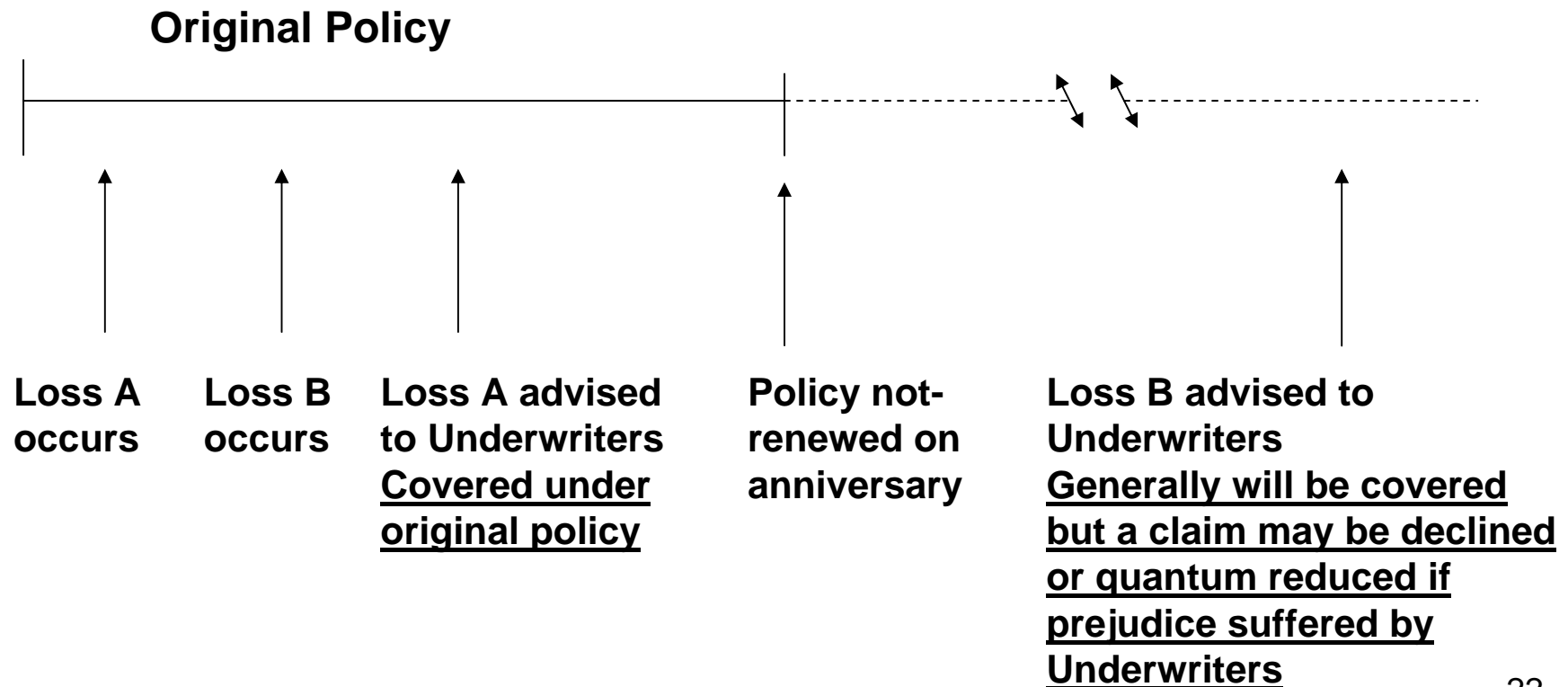
Underlying Discovery Based Policies – Renewed Policy

- 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.



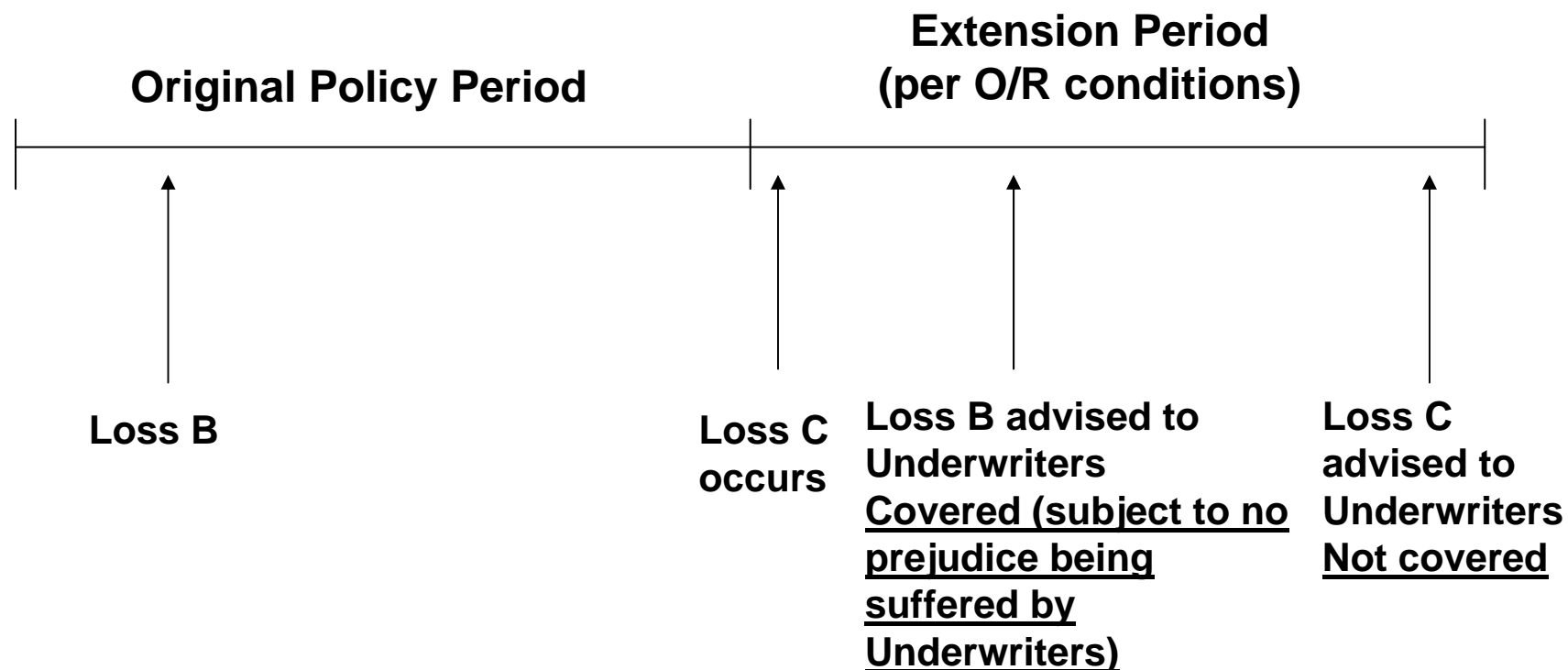
Underlying Loss Occurring Policies - Pre Basel II - Current position

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



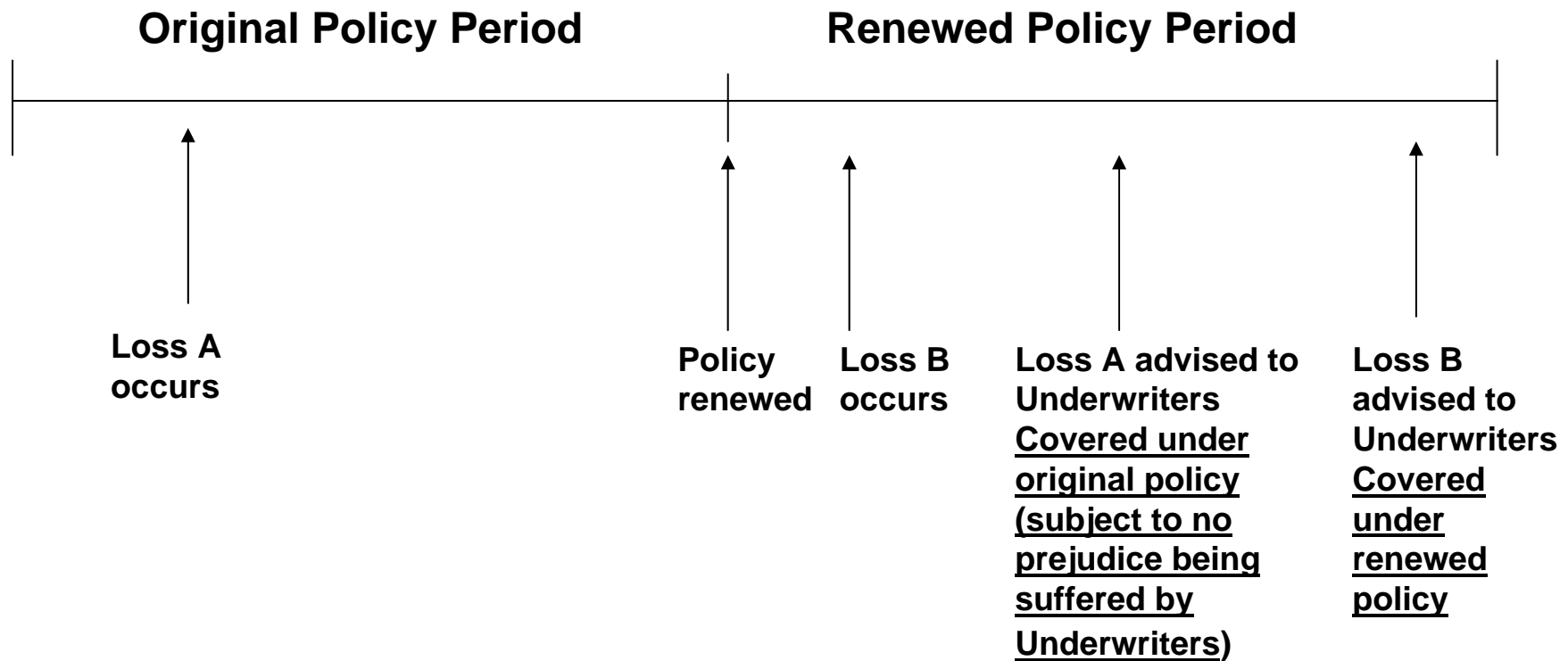
Underlying Loss Occurring Policies - with Basel II solution applied

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



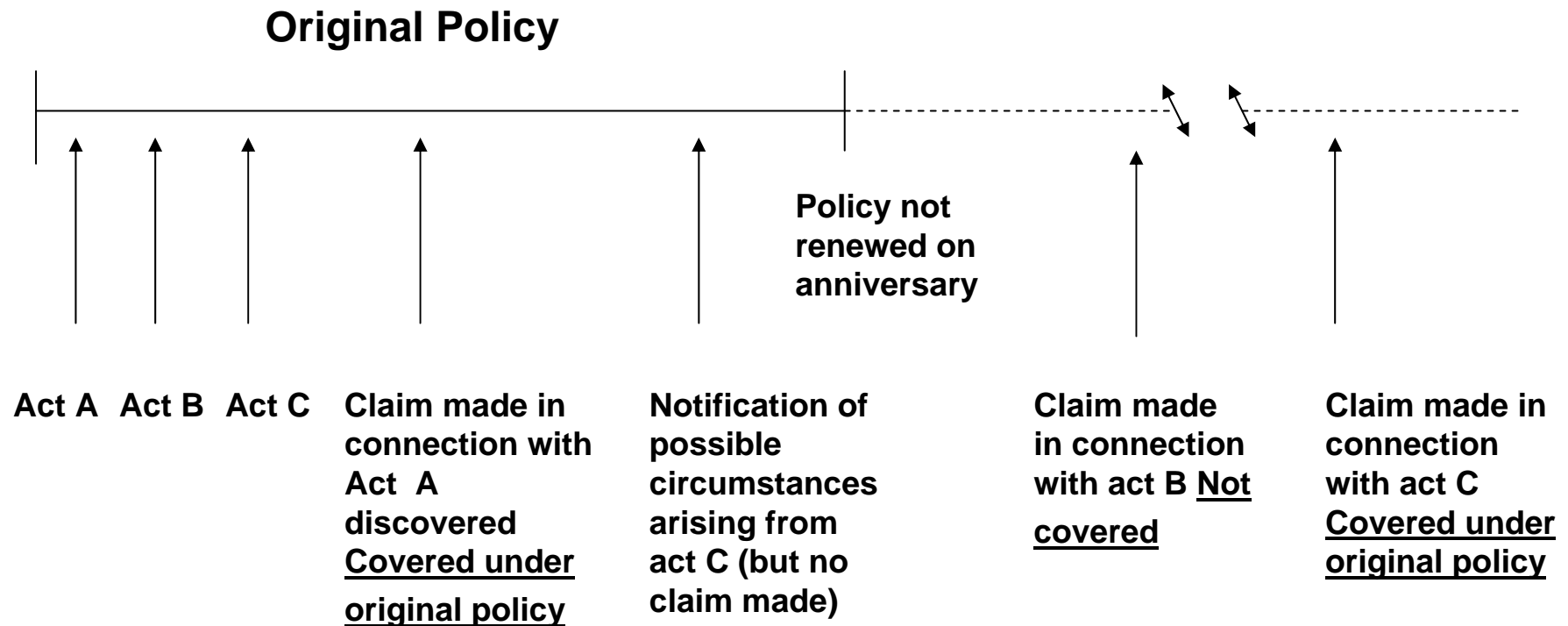
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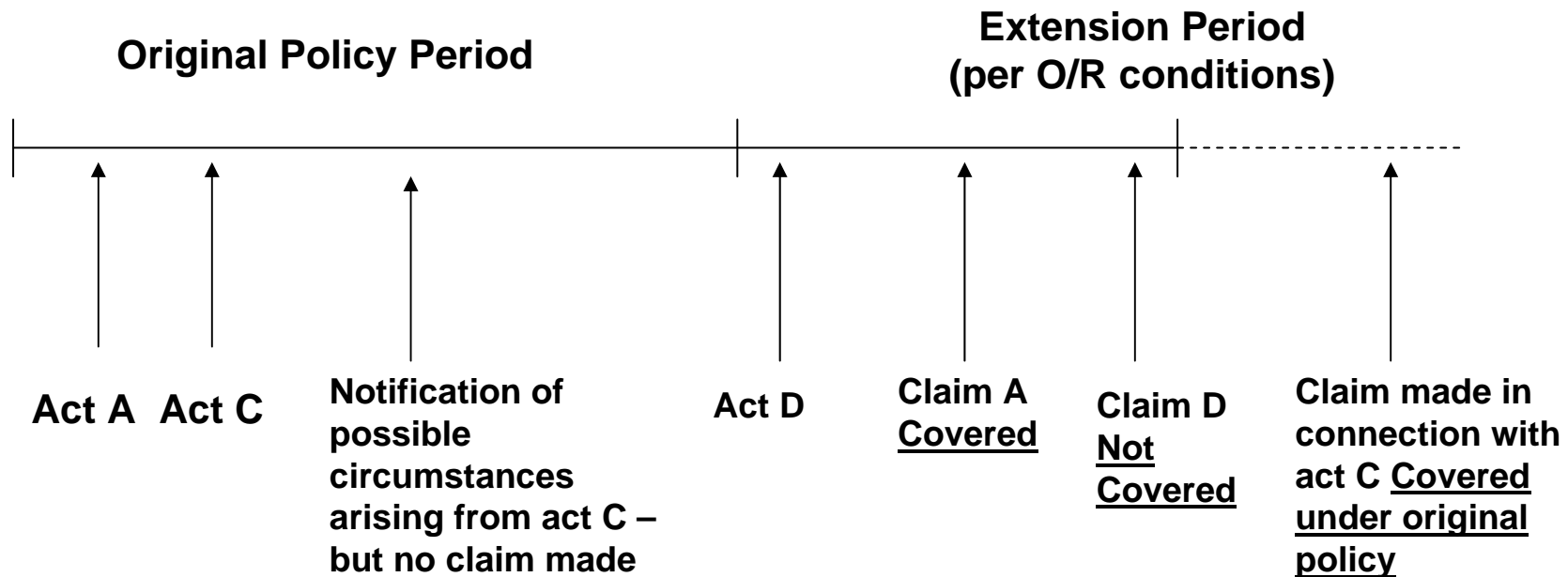
Underlying Claims Made Policies - Pre Basel II - Current Position

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



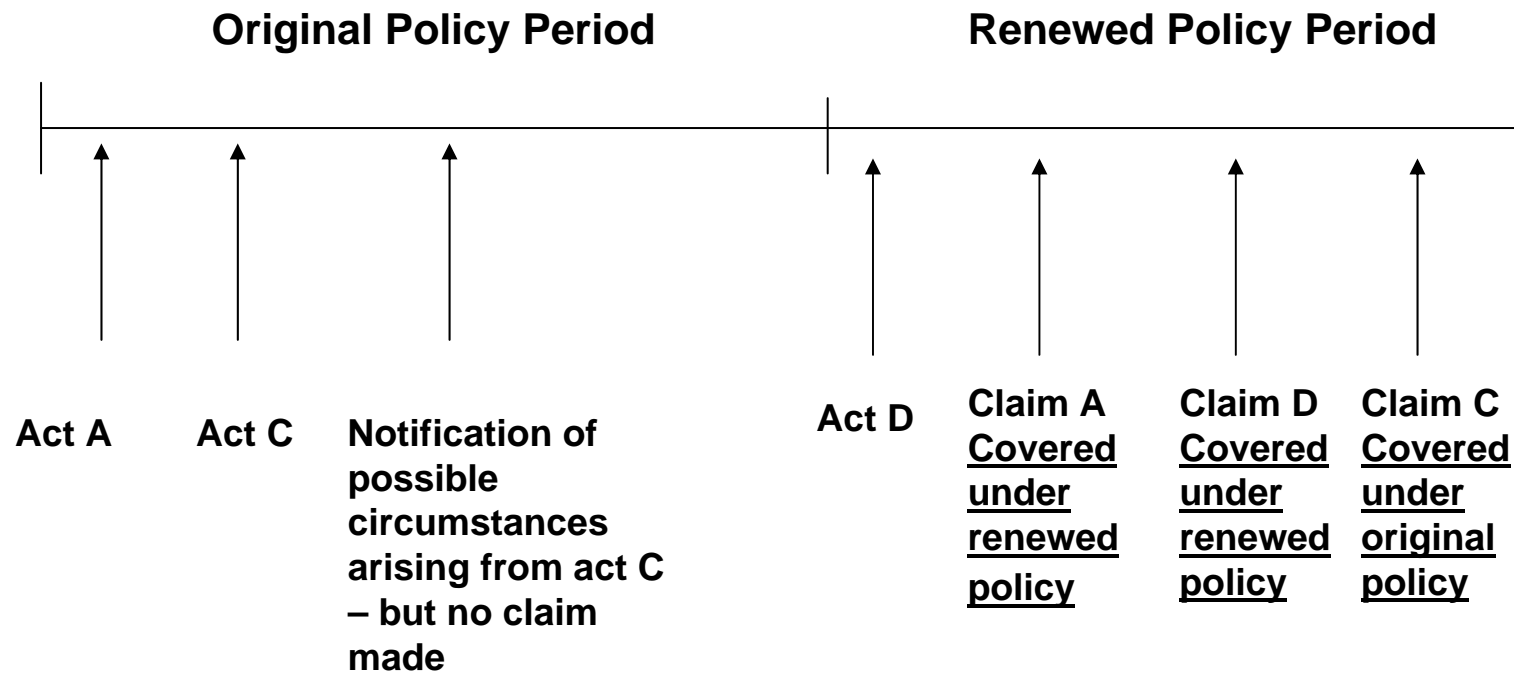
Underlying Claims Made Policies – with Basel II solution applied

- 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:

- 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 (for insurers)
- Scenarios

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