Insurance/ Reinsurance

January 2013

BASEL II

Following the credit crunch and the banking crisis in 2008, issues surrounding the use of insurance policies to mitigate a bank's Operational Risk (OpRisk) regulatory capital requirements were placed on the back burner. Now, Basel II is back on the agenda and the Bank for International Settlements (BIS) has recognised the issues surrounding the use of insurance (as have banks) when it comes to mitigating their OpRisk capital charge (put simply, putting in place insurance policies to cover OpRisk, rather than having to set aside the bank's own capital). There now appears to be a greater understanding and collaboration between insurers and banks as to the risk mitigation qualities which insurances present. BIS sees this collaboration as enuring to all the parties' benefit - banks can improve the alignment of insurance coverages to their risk profile and insurers can achieve a better understanding of the insured's risk, pricing their products accordingly.

From an insurance perspective, it is gratifying that BIS acknowledges/understands a number of issues which, at the outset, led to confusion when contemplating insurances as risk mitigants:

- BIS acknowledges that it will be banks adopting the Advanced Measurement Approach (AMA) to OpRisk who will be the principal beneficiaries of any reduction in capital risk charges, although the discipline which it imposes will be of benefit to banks adopting the Basic or Standardised Approaches. The "Approaches" reflect the various gradations of OpRisk and how such risk is effectively managed. The intention is that over a period, banks will move towards becoming an AMA bank.

- Insurances should be recognised as a risk mitigant, not a substitute for capital. Therefore, banks need to show that their insurances map in to the risks themselves and are not used for capital arbitrage. Where high deductibles are agreed, BIS advises regulators to consider whether risk mitigation is occurring or capital arbitrage

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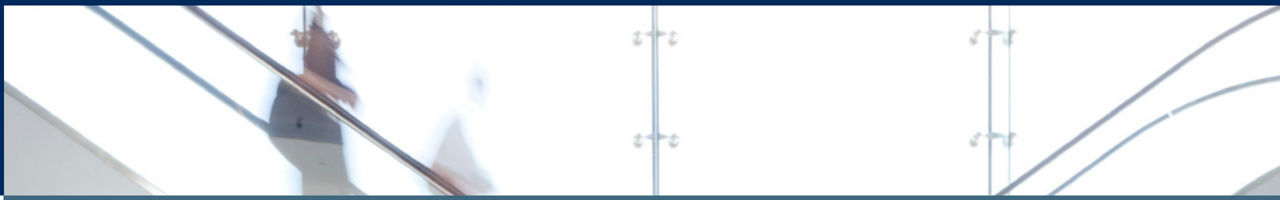


(which, to some extent, is an unavoidable by product of the role which insurances play in risk mitigation).

- In order to fully understand the value of the insurances, banks will need to collate information in connection with the risks they face and losses suffered, as well as the performance of their insurance programmes (in terms of the likelihood of claims being paid and the timing of such payments, e.g. if banks are permitted to incorporate insurances into their models, they will need to take into account the actual availability of the insurance proceeds relative to the capital that they are required to hold at that point in time in connection with OpRisk). Further, it is likely that regulators will require risk mitigation structures to have been in place for some time, before they recognise their worth. In addition, the bank will have to show:

    - The risk mapping process is conducted with integrity (and the bank is capable of providing the information and the methodology used in the mapping process).

    - The process is examined regularly and the appropriate expertise is employed.

    - The performance of insurance (i.e. payments) is taken into account.

    - The appropriate risk committee approval is obtained.

    - It has appropriate processes in place to ensure that its duty of disclosure requirements can be met - in the event that a policy is void through non-disclosure, the bank should inform its regulator, so that its AMA capital can be recalculated.

If these processes are not followed or, for example, if the prevailing economic circumstances change, then this can lead to a revocation of approval for recognising any capital risk charge.

- It is incumbent on banks to make their cases (with the assistance of external expertise e.g. claims counsel, brokers and insurers) to the regulators for a “haircut” in connection with their OpRisk capital; regulators cannot make the case or review the programmes to any significant degree. BIS also makes the point when providing the insurances that it is for underwriters and brokers to satisfy themselves that the bank in question is an AMA bank.

- BIS acknowledges that globally there are variations in the treatment of insurances for the purpose of AMA banks and this, in turn, results in legal/regulatory arbitrage.

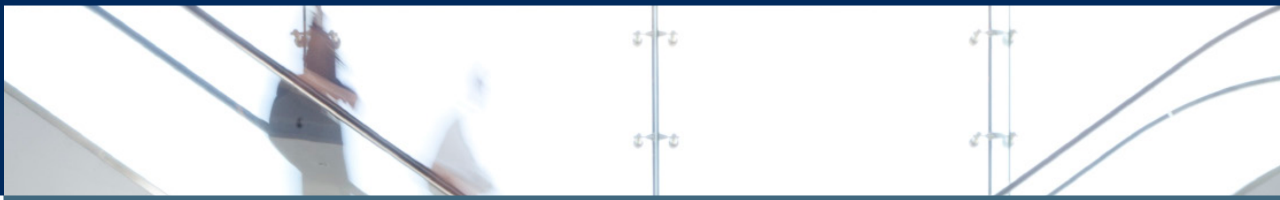
- The maximum 20% haircut (i.e. a reduction in a bank’s capital which it is required to set aside to address OpRisk) was intended as a cap, not a benchmark, and it was widely known that the full cap would not be achievable. Indeed, the Loss Data Collection Exercise for Operational Risk performed for North American and European banks in 2008 found that for a quarter of the banks that could benefit from a haircut, the maximum achievable was 3.7% (admittedly this was at an early stage of the process).

- There clearly are systemic risks where bank risk is transferred to a limited number of insurers (not least from an aggregation point of view).

Moving onto the requirements which were contained in the original Basel II paper (*International Convergence of Capital Measurement & Capital Standards: A Revised Framework - June 2006*), many of the issues which had originally been raised in 2005 had been addressed by insurers at the time. However:

- The insurers had to have a claims paying ability rating of A (or equivalent). This requirement perpetrates the misconception that paying ability could be rated (when it was the credit rating of the insurers that was actually being rated i.e. one could have a AAA rated insurer that did not pay claims (quite possibly for good reasons)). As insurers (and brokers) will be aware, there already exist mechanisms in connection with determining whether an insurer is adequate security and if they are deemed not to be then their security can be replaced. The certainty of payment is a separate issue and much will depend on careful negotiation of the coverage.

- The policy must have a residual term of not less than 12 months at any point in time. This has



been addressed in a number of ways e.g. granting a two year policy which is cancelled after the first year; a mandatory renewal after the first 12 months with a prohibitively expensive break clause (if the bank refuses to renew); a continuous rolling (evergreen) policy. In addition, BIS highlighted issues which might arise if there was a renewal of cover and the tension between the expiring and new wording, and whether it is sufficient to have the same cover and what changes in cover have to be made (limits, insuring clauses, general conditions and exclusions), before the risk mitigant needs to be re-evaluated.

- The use of captives still causes some concern to BIS, the reason being that if the captive is not sufficiently capitalised and the reinsurer is unable (or unwilling) to meet the claim, then the claim will fall on the captive. As will be apparent, this objection is flawed - if the reinsurer is unwilling to pay the claim (because it is not covered), then this will make no difference to the captive, which is unlikely to pay the claim (assuming that they are underwriting on the same terms). However, if the reinsurer cannot (financially) meet the payment then this clearly impacts the captive and non payment, of claims may have wider, solvency ramifications for the captive.

- As for other policy/wording requirements e.g. the 90 day cancellation provisions (by insurers); no exclusions triggered by regulatory actions, these have not presented difficulties for underwriters.

The principal message emanating from BIS is that it is incumbent on the banks to perform the work in mapping their risks onto their insurance policies. BIS acknowledges that certain risks cannot be shoe horned into policies (or at least the wordings currently available) and it is incumbent on banks that wish to avail themselves of risk mitigants to collate the relevant information and *"to investigate the uncertainties, responsiveness and characteristics of their policies, including uncertainties of payment, mismatches of cover and exhaustion of policy limits."*

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