

# Specialty Practice Briefing

*An Update from the Professional Liability Specialty Practice*

June 2007

## Basel II – A Review for Reinsurers

*This briefing presents a summary of a Guy Carpenter seminar held on 4 May 2007, where representatives from the insurance, reinsurance, legal and banking sectors discussed the implications of the Basel II Accord for the insurance industry.*

### Introduction

***George Carrington, Worldwide Professional Liability Specialty Leader, Guy Carpenter***

The Basel II Accord – or more properly the New Capital Accord of the Basel Committee on Banking Supervision – was published in June 2004. It has to be said that the insurance market was slow to recognise the importance of Basel II to its more sophisticated banking clients who are taking the advanced measurement approach (AMA), for measuring their regulatory capital requirement. More specifically, insurers were slow to consider the role insurance can play for the AMA banks.

With the adoption of the Basel II provisions by the EU, the larger banks are now looking to insurers of financial institutions to respond to their needs, and these insurers in turn are looking to their reinsurers to play their part in responding to the needs of the ultimate customers.

The purpose of this seminar was to provide a forum for reinsurers to discuss the insurance issues arising out of Basel II.

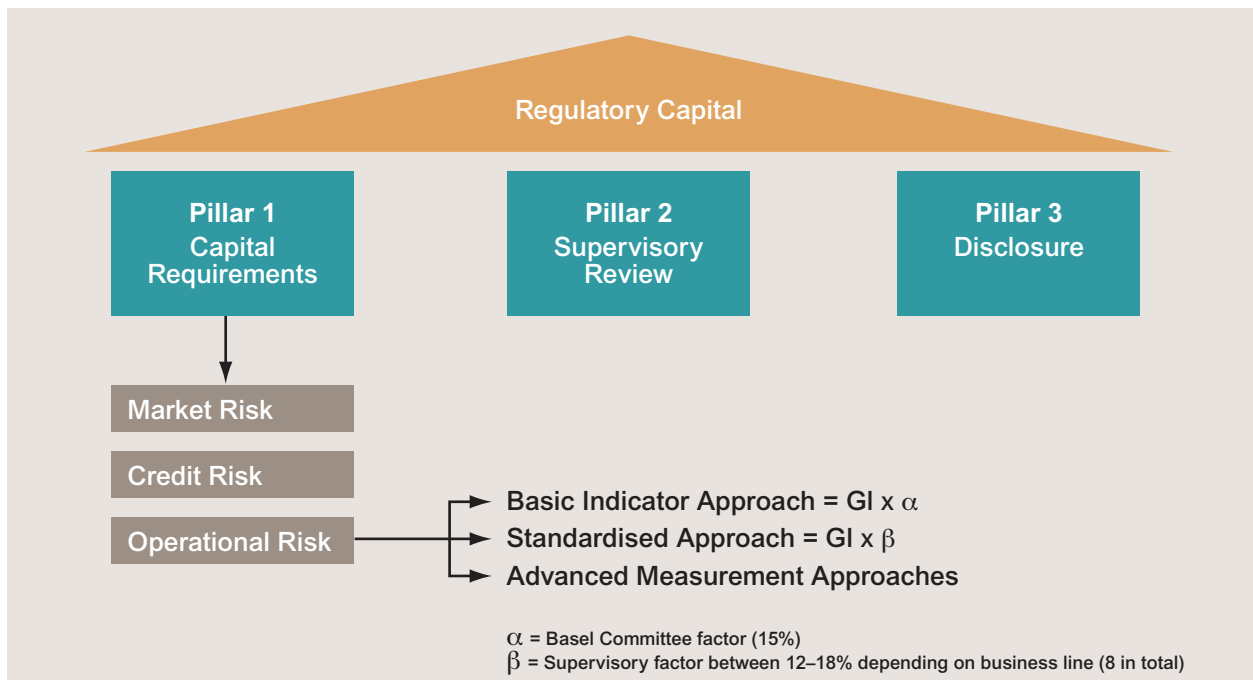
### Basel II Regulatory Capital Provisions

***Paul Search, Senior Vice President, Financial Service Division of Marsh FINPRO, and UK Leader of Marsh's Operational Risk Consulting Practice***

Following Basel I, which looked at credit and market risk, Basel II introduced a specific regulatory capital requirement for operational risk, namely risk arising through failures relating to people, processes and systems, both internal and external. In order to find the best framework going forward to deal with credit, market and operational risk issues, the Basel II Committee designed the three-pillar approach.

Pillar I deals with calculation of the regulatory capital that banks are required to hold to protect themselves against market, credit and operational risks. Pillar II covers supervisory discretion: how regulators and banks can effectively discuss and negotiate what should be the actual regulatory capital held. This is an opportunity for the banks to show how they calculate the capital they should be holding to meet their obligations, and how they use insurance and other mechanisms, and to discuss with regulators how they approach risk and link it with capital. Finally, Pillar III relates to the banks' disclosure requirements.

Figure 1: The Three-Pillar Concept of Basel II



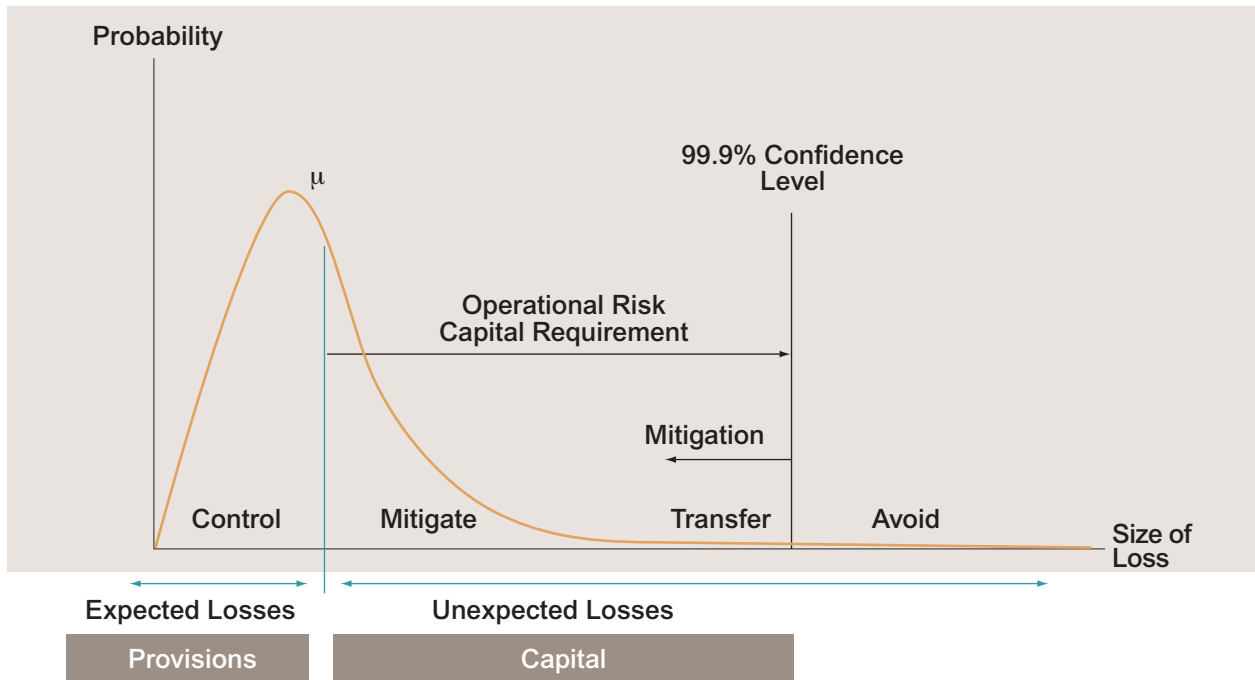
(Source: 'Euroclear and the Management of Risks' presentation at Marsh FMaPP (Financial Markets and Payments Practice) training seminar, London, 1 March 2005.)

Calculating the regulatory capital required is a highly complex process, particularly in relation to operational risk. Banks do not have the same amount of experience and data here as they do for credit and market risks, which are therefore relatively predictable in comparison. The three available approaches to holding regulatory capital are:

- The basic indicator approach, aimed at smaller institutions without significant international operations. Calculations are based on 15% of a three-year average of positive gross income.
- The standardised approach. This is calculated by dividing operations into eight segments and assessing the inherent risk of each, with a range of 12–18% of a three-year average of positive gross income.
- The advanced measurement approach, which requires banks to adopt a sophisticated approach, calculating their own regulatory capital for operational risk and then negotiating agreement with the regulators.

A bank adopting the advanced measurement approach is required to develop a sophisticated and comprehensive methodology to quantify its operational risk. This, under Basel II, is defined as the 99.9th percentile of the distribution of potential aggregate losses, within a one-year time horizon.

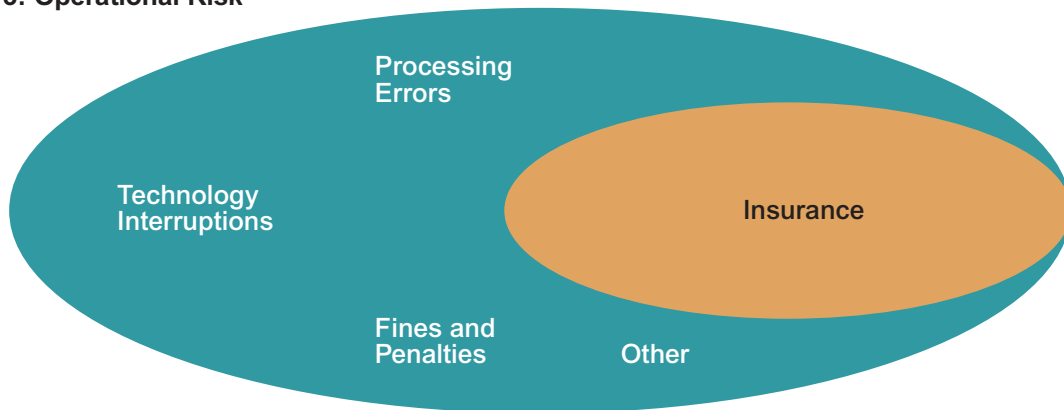
**Figure 2: Theoretical Loss Distribution**



(Source: 'Euroclear and the Management of Risks' presentation at Marsh FMaPP (Financial Markets and Payments Practice) training seminar, London, 1 March 2005. Amended by Guy Carpenter.)

For those banks adopting the advanced measurement approach, there is the ability, subject to specific requirements, for the capital calculation to recognise the mitigating effect of insurance in reducing operational risk exposure.

**Figure 3: Operational Risk**



In terms of total operational risk, insurance is important for AMA banks. Between 20% and 30% of all operational risks are covered by some form of insurance. Furthermore, AMA banks have the opportunity to get regulatory capital relief for insurance up to 20% of their total capital risk charge. However, a number of qualifying criteria apply for banks to achieve this and if banks are to benefit from this approach, it is clear that the insurance market must reduce the amount of conditionality inherent in traditional policies.

## The Legal Position

### *Angus Rodger, Partner, Steptoe & Johnson*

If banks are holding regulatory capital to protect against operational risks and if they also have insurance covering some of the same risks, Basel II gives them the possibility to reduce the amount of capital that they have to set aside. However, in order to obtain this concession, the bank in question must be able to demonstrate that its insurance policies cover the risks in question and that these are sufficiently robust so that the bank will be paid if the risk materialises. The Basel II Committee has laid down various criteria to help regulators decide if the insurance is robust enough.

- 1 ***The insurer has to be a suitable insurer.*** The insurer must be an 'arm's length' insurer (or a captive reinsured by an arm's length reinsurer). The (re)insurer should have a minimum credit rating throughout the life of the policy, and so an effective mechanism should be designed to replace a (re)insurer who is downgraded during the period of cover. For example, in the case of insurance with a subscription market, this could be a system whereby if one of the insurers is downgraded below A, the bank has the right to substitute an insurer with a rating of A or higher. Different AMA banks may well adopt different financial security requirements for the insurers.
- 2 ***The insurance cover has to be for a period of sufficient length.*** The regulations specify that the policy must have a minimum initial period of one year and a minimum notice of cancellation of 90 days. If the period of cover falls to below a year, the bank would have to accept a 'haircut' as the policy period reduces, i.e. it would get less capital relief as time goes on. There are various ways of avoiding haircuts. One is to have a two-year policy, renewable after one year, for example an 18-month policy renewable after six months, so that the bank will always have one year's cover left to run before any termination becomes effective.
- 3 ***The insurance policy should have no exclusions relating to supervisory actions or insolvency.*** If the bank becomes insolvent, this should not give the insurer the right to exclude claims or losses that are in the pipeline.
- 4 ***In asking for capital relief, banks have to show that there are no mismatches in coverage.*** The bank must demonstrate to the regulator that the risk(s) protected by the insurer are the same as those for which it is asking for capital relief. This will require it to map the risks for which it has to provide regulatory capital and the risks that it is insuring, in order to identify gaps.
- 5 ***Banks must demonstrate that they have resolved any uncertainties of payment.*** Under English insurance law, insurers generally have the right to come off risk or to void cover in the event of non-disclosure or breach of warranty, even if these are innocent and are unrelated to the loss that arises. The concern of regulators is that a technical non-compliance with an insurance contract does not have a major effect on an insured loss and will not permit an insurer to walk away from all claims. This means finding a balance that will satisfy both parties to the contract as well as the regulators.

There is nothing in these five issues that is impossible to achieve. Whilst there are some technical issues that have to be dealt with, the main issue in practice is whether underwriters are commercially willing to agree to the changes that the banks need in order to make their policies compliant.

## Enhancing Insurance Contract Performance

### *Dean White, Managing Director, Financial Services Division, Marsh FINPRO*

When the ability for banks to gain Basel II capital relief through insurance was first discussed, much of the insurance community assumed that the financial institutions would be primarily driving a broadening of coverage. This was a misconception. Another misconception was that there would be a market solution, i.e. a group of underwriters or a broker would be able to design a single product that would become a 'boilerplate solution' for all AMA banks. The issue of operational risk capital mitigation is not about creating a new 'operational risk insurance policy', rather it is about taking the existing insurances that the banks buy and establishing language and approaches to meet the qualifying criteria.

Some of these 'new' elements (to meet the qualifying criteria) have already been dealt with in individual placements in the past. For example, innocent non-disclosure wordings and insurer downgrades clauses have already been used. However, wordings will need to be more robust when linked to Basel II. One instance is specifying a precise and efficient mechanism to replace a downgraded insurer, although this is not a major shift in coverage or policy construction but a straightforward structural issue.

More challenging is the requirement that AMA banks analyse and map their risks to their insurances as part of their assessment of the mitigating effect of the programme.

Whilst this 'gap analysis' process has raised coverage expectations in the financial institution community, this is not necessarily driven by Basel II compliance. It is a consequence of banks having to focus additional significant resources on identifying their risks and looking at the possible scenarios. Some financial institutions have developed highly prescriptive policies. For example, banks want a better fraud policy. However, this is a standard development in the market, merely being confirmed in the context that they understand the risks better, are doing something about them and want their efforts recognised.

Certainty of payment is one of the biggest challenges, not least because the Basel II requirement is rather vague. It will require being more prescriptive about how claims are handled and putting in some timescales.

Thus obtaining capital relief under Basel II is not about creating a market product but about developing a process that can look at an individual bank and an individual regulatory regime and address the specific issues.

Adopting the AMA approach will allow banks to assess the cost of their risk transfer against the amount of their capital relief and decide whether insurance is providing a substantial cost benefit or indeed other benefits such as reputational advantage, increased reliability of insurance and reduced volatility in pricing.

Whilst Basel II affects a wide financial services community, our challenge is on a client-by-client basis. The general assessment is that only 30 to 35 banks globally will initially be taking the AMA approach.

## A Buyer's Perspective

### *David Calvert, Head of Insurance Mitigation, HBOS plc*

The basic reason for the Basel II provisions is consumer protection. In terms of the insurance element of risk management, this means ensuring that insurance is very reliable and more efficient. The need is to convince boards of management that insurance will mitigate when an insured trigger occurs.

The banks that are taking the AMA approach tend to be widespread, if not completely global. In the case of HBOS, there is a big spread of brands and a wide range of activities within the group. In addition, the AMA bank will be different from the bank that (re)insurers have known in the past. The work associated with AMA inevitably changes the risk management profile.

In 1997, banks in the HBOS group began to get to grips with the requirements of Basel II. Between 1999 and 2001, the group worked on modelling to help identify and avoid risks that could be severe. In 2003, the group produced a revised operational risk model. All of this is essential in ultimately convincing the regulator that the bank knows its risks, can control them and so needs to hold less regulatory capital.

The Basel regulators think they know what operational risk looks like. They describe operational risk as the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events. HBOS has translated this into risk categories to suit its operating model. This list of categories includes areas such as human resources, regulatory, policy, services and procurement.

Operational risk has to be genuinely in use and fully embedded into the governance framework of an AMA bank, with appropriate governance information flows. Eventually, this understanding and management of operational risk will be an enabling discipline for banks.

HBOS has over 80 people across the world looking at the operational risk concept and understanding the different categories of risk that can occur. This ensures that the group now appreciates operational risk and will understand it even better in the future, increasing its strength and depth in operational risk management.

HBOS has also developed a mature operational risk framework that is suitable for AMA. Risk categorisation based on the HBOS operating model is driving accountability and ownership of risk portfolios. A consistent approach applies across the entire group in terms of processes and systems that support the framework. There is a business-based approach based on bottom-up assessment, with number-based management reporting to drive management action. The framework has been validated by two external firms, and the aim is to achieve a fully transparent process. The ultimate goal is to use compliance with Basel II and the requirements of the AMA approach to gain a better competitive advantage.

While the HBOS group is strong enough to bear much of its insurable risk itself, it makes sense to buy insurance where insurers can offer attractive terms arising from the way they account for capital and their wider spread of risk across their insurance portfolios. If the insurances are Basel-compliant, the group has the possibility of claiming capital relief under AMA.

The group is modelling its risks and mapping, and is fine-tuning its insurances to make them better aligned to its risk profile. It will continue to buy reliable, efficient insurance policies whose worth can be proven.

## Questions and Answers

**Q: You have talked about managing traditional risks and losses but how do you cope with worst-case scenarios?**

**David Calvert:** Banks making more than £5bn a year cannot buy limits in the insurance market for the worst-case scenarios. The true catastrophes cannot be transferred. On property risks, the spread in the insurance market means that we can get an attractive rate. With liability risks, based on our maximum probable loss, we have to convince our management that insurance is good value.

**Q: Looking at the idea of starting with 24 months' cover and providing roll-on 12 months' cover after a year, what happens if the reinsurance market will not cover this?**

**Dean White:** We are not looking to provide this across the market but on a single case-by-case basis. Direct insurers need to talk to their reinsurers who will, it is hoped, understand the need for a product that shows that the client has the security that comes with the extra 12-month period. Why should the reinsurance market do it? Because it has confidence in the client applying for the endorsement and in the fact that they are managing their risk; it will therefore make an exception for that client.

**Q: It is disappointing that in the UK the FSA has not been as open with the issues regarding Basel II as have the French regulators. We are just starting to see requests for two-year policies from French banks. There has been very little interaction with reinsurers regarding this issue and there are some unanswered questions about how the 24-month policy will operate and how the downgrade provision has been structured. There are more unanswered questions about additional variations, such as whether there is additional premium, a better proposal form, and what taking out exclusions means. There has not been sufficient dialogue in the UK yet. Comments?**

**David Calvert:** In France and Germany, bank insurance practitioners got together and talked to the regulators. In the UK, it is going to come. At HBOS we have been looking at this for some time. Indeed, we talked to the FSA with our insurers to explain what is insurable and what is not, bearing in mind they regulate insurers too and cannot make requirements that contravene or weaken those insurer regulations.

**Q: How extensive will a policy need to be to allow the bank to achieve the full 20% discount?**

**David Calvert:** There are not going to be that many UK banks that initially go for AMA, probably only three, although over time we can expect regulators to impose the disciplines behind Basel onto a much larger number of financial institutions. Some continental banks are taking the view that they can go for 20% on any one of the covers they buy. The UK approach seems to be risk weighted. Until we have established the mapping and comparison between insurance and our risk profile more clearly, we do not know how near we are going to be to the 20% limit. However, we are pushing for better insurances – that are more reliable and efficient – so that our management will want to buy insurance. You will not be asked to give this cover to that many people and, over time will come the ability to differentiate.

**Dean White:** It is not just about broader cover. Taking an existing property policy that has been bought over the last 10 years, banks will want that policy to be of a standard that meets the Basel criteria, but may still have to take haircuts. Better information and risk management will enable insurers to make their decisions. You have to have the confidence in your clients that they are taking that approach. Basel II will drive better information into the market and, it is hoped, drive out volatility and lack of prescription in the market.

**David Calvert:** I believe that some buyers, when their understanding of their risks and losses improves, will be buying less insurance because they will be refining what they want. Some banks may retreat to core covers that everyone can understand.

**Q: Are we likely to see a fragmentation in the marketplace where each of the large banks will have a more differentiated policy than it has had in the past?**

**David Calvert:** If it is worth it. It makes sense for us to carve out some wordings that give us something attractive.

**Q: It seems that there is not as much uniformity between some of the proposed policy wordings. Will we reach a point of uniformity and will it be driven by the insurance market or the reinsurance market?**

**Dean White:** Any uniformity will not be driven by insurers, reinsurers or even direct clients. It will be shaped by what form of words in what legal environment with what regulator and what client, and will depend on whether the methodology is deemed acceptable. There are already differences of opinion among European regulators as to how they are applying the Basel II criteria. Uniformity will depend on what is acceptable in order to meet qualifying criteria for a particular territory.

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