TALBOT UNDERWRITING

Talbot Underwriting Ltd
Gracechurch House
55 Gracechurch Street
London EC3V 0JP

Telephone 020 7550 3500
Facsimile 020 7550 3555
Email central@talbotuw.com

Wednesday 30th July 2003

Talbot Underwriting Ltd Response and submission to the Basel Committee on Banking Supervision On the third consultative paper (CP3) dated (April 2003.) on issues relating to the use and recognition of Insurance in the calculation of the Operational Risk Capital requirements for Banks under the proposed Basel 2 Capital Accord.

Executive Summary

This paper is a response to the third consultative paper (**CP3**) dated 29thApril 2003. Our perspective on the proposed new regulatory framework is that of a long established provider of a variety of financial institution insurance covers in favor of a wide range of banks in terms of size, business complexity and geography. As the consultation process has progressed we have monitored the evolution of regulatory thinking with a particular focus on the potential role insurance may assume as a mitigant of operational risk capital requirements under the new capital framework for banks. With the new framework now entering its final phase we welcome this opportunity to comment specifically on this aspect of the proposed new regulatory environment.

Insurance and operational risk under Basel 2 .

We foresee both the adaptation of existing and the development of new insurance products as banks develop their insurance based operational risk mitigation strategies under the new framework. Insurance is a recognized, long established, highly developed risk management and mitigation tool. The recognition of Operational Risk as a category of risk in its own right under the new capital adequacy framework will, we believe, promote an evolution in the development of insurance offerings and lead to closer collaboration between insurers and their clients in the field of operational risk insurance.

In our view the initial proposals to grant insurance relief to banks on the Advanced Measurement Approach (AMA) only, would have been a strong disincentive to the consistent use of insurance to improve operational risk management amongst non-AMA banks.

In particular, non-AMA banks, which purchase insurance but do not possess the overall capital base to sustain the abnormal or catastrophic losses that their insurance programs are designed to cover, would have been placed at a significant competitive disadvantage to their AMA peers. Although we recognize that the introduction of the Partial Use approach in CP3 is an attempt to alleviate this disparity we believe that the Partial Use approach would benefit from more detailed elaboration in the committee's final proposals. We make specific suggestions in this regard below.

Improved disclosure

The proposed operational risk measurement approaches to be adopted by banks (Basic, Standardized and AMA) will provide insurers with an objective, detailed and audited external yardstick denoting a specified level of expertise in operational risk management processes. Ultimately this will assist insurers in their assessment of individual bank risk, which is a step we view very positively. Similarly the loss data collections exercise under QIS3 has provided a valuable, market wide insight on banks' operational risk losses, previously unavailable to banks and insurers; we therefore strongly recommend the continuation of such industry wide data collection and publication, post implementation of the new accord.

Operational Risk -potential effect on Insurance supply & demand

It is our view that the profile of insurance will undoubtedly be raised within banks as a result of its ability to provide capital relief for operational risk. We believe banks will move quickly to co- ordinate their risk and capital management activities to ensure that where appropriate, the use of operational risk insurance is optimized in the context of capital management. The use of insurance therefore will become an integral part of a bank's management of its Operational Risk. Demand for insurance in such an environment may increase from current levels, in particular from AMA banks as they better understand their risks. Capacity allocated by insurers and reinsurers to the operational risk business for AMA banks may well therefore expand noticeably once the new framework is established and widely applied. It is conceivable in our view, that, in this new environment a flight to quality may occur as insurers and reinsurers effectively exclude or de- select non-AMA banks in favor of AMA banks thereby reducing the availability of insurance to this sector.

We believe this is a potential consequence as the covers required by the AMA sector would be very large and may quickly consume the limits allocated by insurers to the sector. Also the R&D cost of developing an eligible operational risk policy will reinforce the insurers commitment to the sector. Conversely it would be beneficial if this R&D could be recovered by writing eligible business with the non-AMA sectors.

We believe that further clarification in the conditions attaching to the adoption by banks of Partial Use of AMA is necessary to avoid the occurrence of what we are sure is an unintended consequence.

We do not however foresee a loosening of underwriting standards in the new environment of increased demand. On the contrary, our expectation is that disclosure by banks to insurers will be greatly

improved by the newly codified approaches to operational risk identification, measurement and reporting and as a result insurers will be better positioned to assess and price risks.

Notwithstanding this anticipated improved disclosure, the field of insurance of operational risk for Financial Institutions will remain both complex and highly specialized. These factors combined with the proposed 20% cap on the proportion of the operational risk capital charge which may be mitigated by the use of insurance, will avoid any wholesale transfer of risk from the banking to the insurance industry. It is obvious from the consultation process that there is a sharp focus on the extent to which insurance genuinely transfers risk from the insured to the insurer. This is evidenced by the emergence of a variety of discount and haircut factors to be applied to the differing elements of an insurance policy when determining whether or not a policy is eligible for the purpose of providing operational risk capital relief. These elements include inter alia, credit rating, time to maturity, renewal conditions, cancellation provisions etc.

Recognition factors

CP3 was silent on what we believe to be the key component in risk transfer measurement of insurance, namely the recognition factor that is to be applied when calculating the risk transfer value the under either the premium or limit based approaches. As a result it remains unclear how recognition factors will be assigned and calibrated. Similarly it is unclear from CP3 if it is intended to apply a multiple of premium when calculating risk transfer under the Premium Based Approach.
In this regard we would recommend that the recognition factor under any limit based calculations should be set at no less 50% in the committee's final draft. In our view this is an appropriately conservative level below the average payout ratio for insurable losses of 73% derived from the QIS3 loss data collection exercise and as such we believe, both appropriate and conservative. We note in this regard that this payout ratio was derived from data with a 12 months time horizon under QIS3. We would recommend that future loss data collection exercises should incorporate back year's data in order to take account of how longer tail losses develop through to payment.

Our recommendation for recognition factors under the premium based approach is that a multiple of premium should of 1.5x premium should be applied to banks adopting the Basic Indicator approach and a multiple of 2.5x for banks on the standardized approach. However we believe that the limit is a more appropriate factor (Using a tied % approach for Basic and Standard.) in most classes of business that apply. Premiums are always subjected to market forces and as such may not match well against a limit based approach.

CP3 was also silent on whether or not the recognition factor would vary in line with the type of insurance being measured. Will, for example property insurance be rated differently to a professional liability policy? The payment characteristics of the former may be easier to identify and quantify in terms of a recognition factor than the latter. Conversely is it the intended outcome that banks should receive operational risk capital relief by insuring a risk as basic as say property - if so why limit such relief to AMA banks- since this insurance class requires minimal risk management expertise on the part of the insured.

Moral hazard

One critical concern of the insurer in the field of operational risk is the avoidance of moral hazard. The definition of operational risk excludes strategic and reputation risk. We believe one clear benefit of the definition of operational risk to emerge as part of the consulting process, is its great detail.

Given the numerous categories and subcategories into which the causes and constituents of operational risk have been segmented, it would be opportune for the committee in its final draft to identify operational risk components that contribute to moral hazard and should therefore be excluded from insurance cover. Our definitions of the type of moral hazard insurers seek to avoid are those risks related to matters of management judgment, strategic decisions, excluding advice and intentional " within policy" acts of banks and their management, in other words risks or events that lack fortuity.

Uninsurable risks

In a similar vein there is a category of risks which we would define as uninsurable which unlike moral hazard do not arise as a result of the culture of the insured organization but derive from the day to day operations of the business therefore while they form part of the set of Operational Risk definitions thy are excluded by the insurance market.

In our comments on **risk mapping** below we [highlight] those risks, which, we believe, should be excluded from insurance in this way.

Summary

We are confident that the insurance industry working closely with brokers and banks will promptly adapt its products in both form and substance to promote the integration of insurance with bank's operational risk management strategies in the context of the requirements of the new framework.

We recommend that the committee consider the *observations* we make below in relation to valuation of insurance as a risk transfer mechanism in particular as these relate to the calculation of discount factors and haircuts. Our suggestions are intended to provide clarity and a consistency of interpretation to the valuation of insurance as an operational risk mitigant.

****

Specific responses

The format of this submission is to comment specifically on the risk mitigation criteria points 637 – 641 in the CP3 part 2

Risk mitigation

637. Under the AMA, a bank will be allowed to recognize the risk mitigating impact of Insurance in the measures of operational risk used for regulatory minimum capital requirements. The recognition of insurance mitigation will be limited to 20% of the total operational risk capital charge.

The recognition of insurance as a mitigant to operational risk confirms the role insurance can play as an integral part of a bank's risk management program. The 20% cap on its use in the calculation of a bank's net operational risk capital requirement will limit the potential for wholesale risk transfer by banks to insurers. Although the formulae to be used for the valuation of insurance policies in an operational risk context have yet to be finalized, we believe the haircuts and discount factors discussed to date will lead to insurance being too heavily discounted. This observation is expanded in various sections below. As highlighted above we believe it is the regulators intention to capture the essence of the risk transfer achieved through insurance through the use in a to be prescribed formula, of Recognition factors in both the Limit based and Premium based approaches. We recommend that the committee set the recognition factor for the limit based approach calculations at 50%. This is a conservative margin below the 73% payout ratio for insurable losses established by the QI3 loss data collection exercise.

638. A bank's ability to take advantage of such risk mitigation will depend on compliance the following criteria:

- **The insurance provider has a minimum claims paying ability rating of A (or equivalent)**;

This "or equivalent" provision would benefit from clarification in particular with respect to the inclusion or otherwise of an A- rating as an eligible rating. The committee is aware of the variations in approach and terminology employed by the rating agencies. These are listed below for ease of reference.

Agency	CPA Rating	Descriptive	Ratings category	Definition
S&P	A	Strong	Insurer financial Strength rating	Denotes strong financial security characteristics.
Moody 's	A	Good	Long term insurance Financial strength rating. Secure	Denotes ability to meet senior policyholder obligations.
Fitch /IBCA	A	High credit quality	Investment grade	Denotes low expectation of credit risk.
AM Best	A & A-	Excellent	Secure Best ratings	Denotes strong ability to meet ongoing policyholder obligations.

(It should be noted that all of the above ratings are long term ratings whereas the time used in all measurements related to insurance is 12 months)

- **The insurance policy must have an initial term of no less than one year. For policies with a residual term of less than one year, the bank must make appropriate haircuts reflecting the declining residual term of the policy, up to a full 100% haircut for policies with a residual term of 90 days or less;**

Very few insurance policies now have an initial contractual term of more than 12 months, hence under current proposals the value of a policy would be subject to a discount almost immediately it comes into force.

Although it is not yet clear how this specific haircut provision will be calibrated, it appears to be based on the incorrect premise that the payment or risk transfer value of an insurance policy diminishes as its maturity date approaches. Insurance will respond to valid claims irrespective of when they occur within the life of the policy. Therefore the **risk transfer value** of insurance is equal throughout the life of a policy and is not time sensitive.

The haircut proposed in this context, appears designed to address primarily **renewal risk**. We would recommend that no haircut need be applied from the policy inception date and a 100% haircut should be applied only if renewal terms have not been agreed and signed within 90 days of the policy expiry date. This approach will ensure that the operational risk capital mitigation value of an insurance policy is recognized consistently throughout its term applied, and in the event of non-renewal capital relief, (at the maximum rate of 20%) would be "withdrawn" 90 days before the insurance lapsed. This binary approach would promote both prompt renewal negotiations and obviate the need for arbitrary haircuts based on time elapsed which has no bearing on risk transfer.

- **The insurance policy has a minimum notice period for cancellation and non-renewal of the contract;** 94

As footnote 94 below recognizes, non-renewal / cancellation provisions are closely linked in terms of their effect, to the residual life issue addressed in the point above. It would be highly beneficial if a consistent time period were applied to each of these provisions in the final framework.

During the life of an insurance policy there is a continuing dialogue and information exchange between insurer and insured geared towards risk monitoring and ultimately renewal. In this vein the majority of policies contain provisions requiring the insured to notify the insurer of material changes, such as change of control, merger, acquisition etc. In most instances of such changes cover continues on an adjusted basis, normally related to price. Logically however cover may be withdrawn if terms reflecting the new circumstances are not agreed.

More pertinent perhaps is the situation where cover can be cancelled or withdrawn by the insurer without cause. In our experience the normal notice period for **unconditional** cancellation / non-renewal is 30 days. It is quite conceivable however that if necessary to render policies eligible under the new framework, insurers will extend unilateral cancellation / non-renewal periods from 30 to 90 days.

We propose therefore that 60 or 90 days be adopted as a fixed boundary between eligibility and non-eligibility in respect non-renewal / cancellation provisions and for the purpose of a policy's residual term. We would caution against making this period any longer than 90 days however.

Footnote 94. **The Committee recognizes that the length of the minimum notice period for cancellation and non-renewal of a policy may present challenges for recognizing insurance contracts in regulatory capital. During the comment period, the Committee will continue to work with the industry to define the minimum threshold. Consideration will be given to developing a consistent treatment of the residual life of an insurance policy and the cancellation and non-renewal period.**

- **The insurance policy has no exclusions or limitations based upon regulatory action or for the receiver or liquidator of a failed bank;**

It is normal industry practice for an insurer to automatically cancel cover upon the appointment of a receiver, administrator, liquidator or equivalent. This provision for example, appears in one form or another, in the following policy types: Bankers Blanket Bond (BBB), Electronic Computer Crime (ECC), Unauthorized Trading (UAT), Directors and Officers (D&O), and Professional Liability (PL) insurance.

It is important that the final draft clarifies what is the intended scope of the term regulatory action. It should be noted that insurance routinely excludes from cover payment or reimbursement of any fine or penalty levied by governmental or supervisory act, or any other costs resulting from supervisory action / intervention across the financial sector as a whole. The appointment of a liquidator or receiver to an insured institution triggers a change in an insurers approach to the risk. An intervention of this kind denotes a distressed risk, while insurance will remain liable to pay any claims up the to to the date of the appointment point of the receiver ongoing cover would generally cease. It is commercially possible that insurers would re- approach the situation and possibly provide cover for 1st party losses, but 3rd party cover in such circumstances is not foreseeable. The core of this issue from an insurer's perspective is that the appointment in addition to denoting distress breaks the commercial basis on which the insurance contract was struck hence cover is discontinued.

As drafted this provision will seriously impair an underwriter's ability to structure an eligible insurance policy.

- **The insurance coverage has been explicitly mapped to the actual operational risk loss exposure of the institution;**

As underwriters we are wholly supportive of any measure that reduces the risk of misunderstanding and /or misinterpretation of the scope insurance coverage offered by a policy.

We have completed an exercise which compared the detailed definitions of the causes of operational risk, under the headings **Internal, External, People, Process** - down to sub category level 3), with available insurance policies. This exercise confirmed both the broad range of protection which existing, defined insurance covers can provide as well as the feasibility of risk mapping in an overall operational risk context.

As a result of this risk mapping [which is available on request] we believe that new insurance policy structures can and will be developed to incorporate the detailed operational risk definitions in the relevant insured risks sections. This in turn will promote the expanded use of common risk terminology insurers and their clients and facilitate supervisory reviews of the insurance policies themselves.

The level of detail with which risk mapping can now be conducted with respect to operational risk and the adoption of common definitions facilitate the identification of risks that which can be linked to Moral hazards or are otherwise uninsurable. We recommend that the final draft regulations specifically exclude those linked to Moral hazard from insurance.

Examples :
Deliberate money laundering
Lack of suitable employees
Losses through reconciliation failure

- **The insurance is provided by a third party entity. In the case of insurance through captives and affiliates, the exposure has to be laid off to an independent third party entity, for example through re-insurance, that meets the eligibility criteria;**

We believe the proposals regarding the role of captives in insurance would benefit from significant amplification in the final draft proposals

.
Firstly it should be clarified whether or not the capital built up in a captive organization will be included in the institutions consolidated risk capital calculation.

It is logical that AMA banks whose insurance planning involves the use of captives, should be concerned that these arrangements be taken into account when the operational risk capital requirement is assessed. As drafted this provision appears, de facto, to exclude banks using the standardized and basic indicator approach, which also have established reinsurance arrangements in place via their captives. Captive arrangements can build up potentially significant capital resources as a fund against catastrophic events. By effectively limiting the use of captives to AMA banks the regulations will place captive owning, non-AMA banks at significant disadvantage, even if their structures transfer risk adequately under the standards of the new framework.

We would request clarification therefore as follows; will re insurance under captive programs only be considered if the underlying insured is an AMA institution? By extension, what will be the approach to the partial adoption of AMA by a bank, whose reinsurance program adequately transfers the operational risks of a range of business lines for which it has not adopted the advanced measurement approach?

We note also in this regard, that a re- insurer has no contractual relationship with the insured bank and in our view this provision places an undue burden of reinsurance program analysis, onto the regulator. This provision also raises the question of transferability of eligibility. Under the captives scenario the relevant rating is that of the re-insurer, in the event of a primary insurer being rated below the required minimum level, does the committee propose to “look through” that insurer to the rating of its reinsurance when considering the eligibility of its policies?

[An issue linked to this concept of looking through insurance to the re insurance is that of ensuring preferential creditor status]

[AMA banks will require large limits and capacity from re insurers. The reinsurance community should be invited to respond as regards their appetite for risk in this regard].

- **The framework for recognizing insurance is well reasoned and documented;**

We agree with this overall approach.

- **The bank discloses the reduction of the operational risk capital charge due to insurance.**

We agree with this overall approach

639. A bank's methodology for recognizing insurance under the AMA also needs to capture the following elements through discounts or haircuts in the amount of insurance recognition:

- **The residual term of a policy, where less than one year, as noted above;**

Per our response to point 638 we recommend that only a policy with less than 90 days residual term should be subject to a haircut and receive no recognition for the purpose of capital relief. We do not believe there should be any other time to maturity-based haircuts imposed.

- **A policy's cancellation and non-renewal terms;**

Our recommendation per point 638 above is that 60 - 90 days is an appropriate trigger / boundary for all these provisions and that the relief granted should be binary, i.e. either 100% or 0%. This approach has the advantage of consistency and clarity.

- **The uncertainty of payment as well as mismatches in coverage of insurance policies**

Where policies do not specify the operational risks to which they map and intend to over, no relief should be allocated, this will ensure that all parties to the policies both map and record the risks being taken / insured. We equate "uncertainty of payment" as a reference to the need to measure the extent to which insurance is transferring risk. As stated above we recommend that this factor be set at least 50% in the committee's final draft. This is a conservative margin below the pay out ratio for insurable losses derived from the QIS3 loss data collection exercise and as such we believe appropriate. In our view it is critical that this recognition factor is appropriately calibrated and we are opposed to any concept that introduces an element of subjectivity regarding a likelihood of payment into the assessment of risk transfer. Although CP3 is silent on recognition or discount factors in respect of "uncertainty of payment" Any "likelihood of payment" factor that is to be included in the insurance calculation that the regulator either accepts or declines, should be prescribed and consistently applied. This provision would benefit from clarification in the final draft.

D. Partial use

640. A bank will be permitted to use an AMA for some parts of its operations and the Basic Indicator Approach or Standardized Approach for the balance (partial use) provided that the following conditions are met:

- **All operational risks of the bank's global, consolidated operations are captured;**
- **All of the bank's operations that are covered by the AMA meet the qualitative criteria for using an AMA, while those parts of its operations that are using one of the simpler approaches meet the qualifying criteria for that approach;**
- **On the date of implementation of an AMA, a significant part of the bank's operational**
- **risks are captured by the AMA;**
- **The bank provides its supervisor with a plan specifying the timetable to which it intends to roll out the AMA across all material legal entities and business lines. The plan should be driven by the practicality and feasibility of moving to the AMA over time, and not for other reasons.**

We believe the committee should allow data pooling from non-AMA banks to reach the right level of awareness of risk, and provisioning.

We view the introduction of the partial use provision as a positive step, which will encourage banks to optimize their operational risk capital positions without needing to be willing or capable of using AMA on an enterprise wide basis from the date of initial implementation. The final draft should specify if December 2005 parallel-running deadline for implementation by AMA banks also applies to those electing partial use. We would however question the logic and purpose of requiring a bank that elects partial use, to establish a timetable for converting all of its business to an AMA approach. In our view if a partial use bank satisfies its national regulator with regard to its adherence to AMA standards for a significant part of its business, it should not be obliged to apply a timetable to convert the balance of its business to AMA. In support of this view we note that this provision regarding the need to establish a timetable to convert to an enterprise wide approach had been removed from the IRB advanced measurement approach to credit.

641. Subject to the approval of its supervisor, a bank opting for partial use may determine which parts of its operations will use an AMA on the basis of business line, legal structure, geography, or other internally determined basis.

We agree that national regulators should be empowered to determine whether the partial use election covers a significant part of a bank's business in terms of materiality. However, per our comment to point 640 above we believe it is inconsistent to impose a timetable for full conversion to AMA. We believe that a bank's local supervisor should determine whether or not a partial use AMA bank should be obliged to convert to full AMA status, particularly if all non material risks are being captured by other measures, to the satisfaction of the regulator.

TALBOT
UNDERWRITING

This paper has been complied by Talbot Underwriting Ltd. (TUL), an agency who manage Syndicate 1183 at Lloyd's.

Syndicate 1183 is a Lead Financial Institutions Underwriting syndicate in the Lloyd's and London market.

The members of the Talbot Operational Risk Response team were:-

- Mark Johnson (Director of TUL.)
- Alan Day (Consultant.)
- Robert Stansbury (Director of Quadrant Risk Management (International) Ltd., and Non-Executive Director of TUL.)

Mark S Johnson ACII
Director, Casualty Underwriter
TAL Syndicate 1183