Comments of Willis Limited to the
Basel Committee on Banking Supervision on the
Third Consultative Paper regarding
The New Basel Capital Accord

Introduction

One intention of The New Basel Capital Accord is to foster an awareness and high standard of management of operational risk among internationally active banks. The importance attached to this is highlighted by the introduction of a requirement for the setting aside of operational regulatory capital.

Suitably structured insurance forms an integral part of operational risk management and this is acknowledged in The April 2003 Consultative Document - "CP3". Both the banking and the insurance industries should be encouraged to develop a deeper understanding of risk management and mitigation techniques. Clarity of guidelines for the acceptability of insurance is therefore to be welcomed. The following areas may, however, be deemed worthy of further consideration.

637. "Under the AMA, a bank will be allowed to recognise the risk mitigating impact of insurance………"

Regulatory capital recognition of insurance will be limited to banks adopting the AMA. However, the risk mitigation value of identical insurance policies does not vary with the sophistication of their insureds. Whilst, therefore, risk measurement afforded by the Basic Indicator or Standardised Approaches may be relatively imprecise, we consider that those banks adopting these approaches ought also to receive some Pillar One regulatory encouragement to make use of appropriate insurance.

638."The insurance policy has no exclusions or limitations based upon regulatory action or for the receiver or liquidator of a failed bank"

This proviso raises two points:

> Whether insurers are willing or able to issue insurance contracts covering operational risk events without such exclusions or limitations.
>
> If an insurer were willing to do so, would such an insurance policy be enforceable?

We have contacted a number of major specialist financial institution insurers operating in the London Insurance Market to seek their views on this matter. (See appendix). Comments received indicate that specialist financial institution insurers are keen that their operational risk event insurance policies should comply fully with the qualification provisions of the final requirements of The New Capital Accord because their insured banks are expected to seek to maximise potential insurance mitigation. They have however questioned whether this particular proviso will have its desired effect.

Most insurers believe that when a bank goes into liquidation or is taken over by a regulator, insurance cover for "ongoing acts" should cease. This does not mean that all insurance cover automatically stops from that date for acts that may have occurred prior to that date. Most specialist insurance policies, such as Bankers' Blanket, Professional Indemnity etc. are arranged on a "losses discovered" or "claims made" basis. That is to say they usually cover acts occurring during the policy period that are discovered during the policy period or claims that are made during the policy period arising from such acts. However, extended discovery or reporting extensions can be written into insurance contracts. These provide that, although insurance cover will have ceased on the day of the event triggering cancellation, a subsequent "operator", such as a liquidator or a regulator, will have time to discover losses or manage claims made after that day, provided they arise out of "acts" occurring on or before cessation.

Similar provisions apply in typical commercial merger or acquisition situations where insurances of the acquired party are often cancelled but extended discovery or reporting periods are negotiated. These are typically known as a "run off" provisions.

The second issue that Insurers raised is more fundamental. They have always considered that when a bank goes into liquidation, the legal process transfers asset ownership from the shareholders to the liquidator and that this process invalidates an insurance policy, there being no "privity of contract" between the Insured and the liquidator. In the United Kingdom it is normal practice upon the appointment of a liquidator for the liquidator to review completely the failed entity's insurance portfolio in conjunction with a newly appointed insurance adviser/broker and, wherever required, to put in place new insurances. Usually, new insurances will be effected to protect the assets because the insurance arranged by the former owners of the assets cannot be relied upon once they have been transferred.

Thus the absence of any "comments" concerning regulatory action or that of a liquidator may allow a cancellation event to render insurances invalid - the opposite effect to that being sought.

It may be that specific provision should be incorporated into an operational risk event insurance to ensure that coverage remains in force for the benefit of a regulator or liquidator as regards acts occurring in the period up to the regulatory intervention or liquidation. This would allow the regulator or liquidator time to formulate a claim or prepare a defence in respect of potential litigation resulting from such acts. This is an area warranting further consultation before specific criteria are finally established.

638."The insurance provider has a minimum claims paying ability rating of A (or equivalent);"

In recent years the strict application of insurance premium tax across the EU, where rates of tax vary from 2% +/- to 20% +/-, has lead to more direct local insurance policy issuance and less direct single global policies. Replacing global insurance with a local insurance structure would be a retrograde risk management step. Most global banks have therefore adopted the concept of purchasing global operational risk event insurance polices and arranging for these to be represented by local policies using the technique known as “fronting”. (Here, a local insurer issues a policy in respect of the assets or interests of the bank in its country but is reinsured, often 100%, to the global master insurance contract).

In countries where there are no "A" rated or better insurers licensed to operate it will be impossible for a bank to arrange such fronting.

We suggest that allowance should be made for these arrangements to be encompassed within the provisions of CP3, perhaps making use of a " cut through clause". Such clauses are widely used within the insurance industry and create a contractual relationship between the bank, the fronting insurer and its reinsurer(s).

638."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;"

This paragraph addresses two issues:

> Insurance must be provided by a truly third party entity (by inference that meets the eligibility criteria of 638)
>
> Where insurance is provided by a captive or affiliated company the exposure must be “laid off” to an independent third party e.g. by re-insurance, and the independent third party must then meet the eligibility criteria.

We appreciate that a true transfer of risk can only be achieved where the transferee stands independent of the transferor. Transfer from a bank to a captive beneath the same holding company umbrella is no transfer at all on a consolidated basis.

There are, however, instances where a captive or an affiliated insurance company carries an "A" rating in its own right quite independent of its ownership or affiliation. In such cases, the transfer of risk might be regarded as qualifying as if the the insurance company was an independent third party. Accordingly, we suggest that the following amendment might apply.

The insurance is provided by a third party entity that has a minimum claims paying ability rating of A (or equivalent). In the case of insurance through

captives, affiliates and third party entities that do not have a minimum claims paying ability rating of A (or equivalent), the exposure has to be laid off to an independent third party entity, for example through re-insurance, that meets the eligibility criteria. In this instance the term "third party entity" may include captive or affiliated insurance companies provided that they are separately capitalised and are not reliant upon parental guarantees to substantiate the rating of A (or equivalent)

We further recommend that this provision be augmented by clarification of the term "laid off". The term implies that the captive should pass on the risk to a third party by way of reinsurance. There have, however, been instances where reinsurance has failed to parallel the original insurance contract. On occasion, a captive has been legally obligated to pay a claim in accordance with the insurance policy issued to its client (the bank) but the reinsurers have been able to argue that they are not so obligated. If this is indeed the intention of regulators, the uncertainty can be eliminated by the inclusion of a "cut through clause" referred to above.

24th July 2003

Appendix

Wording of an enquiry sent to various interested parties regarding CP3 insurance policy provisos

The latest Consultative Document from the Basel Committee on Banking Supervision relating to **The New Basel Capital Accord** and dated April 2003 states that, under the AMA, a bank will be allowed to recognise the risk mitigating impact of insurance in the measure of operational risk used for regulatory minimum capital requirements. (The recognition of insurance will alleviate up to 20% of the total operational risk charge and the taking of such a mitigation will need to be disclosed).

Paragraph 638 of the Consultative Document sets out the criteria and rules by which operational risk event insurance will be assessed as suitable for the "discount". Most of these can be addressed in negotiation or will require work by the risk manager in conjunction with his broker/insurer but are not insurmountable.

One item has caught us slightly by surprise namely a requirement that operational risk event insurance policies shall contain "no exclusions or limitations based upon regulatory action or for the receiver or liquidator of a failed bank".

As you are aware most standard Bankers' Blanket, Electronic & Computer Crime, Financial Institution Professional Indemnity etc. specialist policies issued to banks today do contain a provision whereby a policy is automatically cancelled upon the appointment of a receiver or liquidator or upon the taking of regulatory action. We appreciate that on occasions such provisions have been amended but, prior to this issue being raised by Basel, it would be very unusual to see such provisions removed in their entirety from any such policy.

We expect that several of our clients will wish to discuss this issue with us in the period that has been allowed by Basel to formulate a response or comment of the Consultative Document. We would therefore appreciate your provisional thoughts as to how you intend to address this point and how you think the "Financial Institutions Market" as a whole should react or respond to this.

We look forward to your comments.