

# Insurance Day

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## Basel II, set-aside capital and benefits of insurance



**ANGUS RODGER** considers how banks can use insurance to save money and how insurers can establish new business

amount and the capital relief alone could be enough to cover the cost of buying the insurance several times over.

As a result, insurers may see renewed interest from banking clients which had previously been moving towards self-insurance. Although most insurers are not looking to provide more liability coverage to banks at the moment, Basel II applies to other classes of insurance, including property, so long as they relate to operational risks.

For insurers, one advantage of Basel II is that it may be possible to agree a higher premium for a policy if it is to be used to obtain capital relief.

### Criteria

Capital relief is available only to banks which have chosen to carry out a sophisticated assessment of their operational risks and the capital which should be set aside and have negotiated this with the regulator (known as "advanced measurement approaches" or AMA). AMA is a time-consuming process and relatively few banks have chosen to go down this route.

Whether or not relief is granted to an AMA bank at all and, if so, how much of the 20% maximum, are questions for the regulator's discretion. Clearly, it would not be appropriate for the regulator to allow a bank to reduce its regulatory risk capital unless the insurance provides a high degree of protection, especially given current concerns about the state of the banking industry.

The rules therefore set out minimum criteria, which the insurance must satisfy, and these criteria have been the subject of recent guidance from the Committee of European Banking Supervisors.

### Suitability of insurer

The insurer must be authorised to carry on insurance, either by a European Union regulator or an equivalent regime. The insurer must be independent from the insured, so it must not be a subsidiary or under common control. The insurer must also have an adequate claims-paying ability. The lower the credit rating, the less relief the regulator is likely to be willing to grant.

### Period of cover

The insurance must be sufficiently long term. It must have an initial period of one year and if the insurer has the right to terminate the policy the notice period must be at least 90 days to enable the insured to find a replacement policy. The bank would need to recognise in its calculations a reduction in the relief claimed (called a "haircut") for any period when the unexpired policy period becomes shorter than that.

### Exclusions

The policy should have no exclusions relating to supervisory actions or insolvency – so the policy must not give the insurer the right to exclude claims because the bank becomes insolvent.

### Mismatches in coverage

The bank will have to demon-

strate that the insurance covers the same risks as the regulatory capital would (a process known as mapping). If there is a mismatch then the relief will be reduced. Equally, if the remaining amount of insurance coverage is reduced by a large claim, then the bank may need to provide more capital to reflect that.

### Uncertainty of payment

Finally, the bank must demonstrate that it has taken into account any uncertainties of payment. From the perspective of a banking regulator, a typical English law insurance policy is an unusually conditional arrangement: for example, unlike an on-demand instrument, it allows the insurer to decline payment of a claim in the event of breach of warranty or innocent non-disclosure of a material fact.

The bank should demonstrate that it has considered these issues and that they have been taken into account in the amount of relief claimed. The regulator will also expect the bank to have considered its historic insurance data on the payment of its insurance claims – although the payment record for small claims is not necessarily a strong indicator of how a major loss would be handled.

### Conclusion

A bank wanting to obtain capital relief from its insurance policies must go through a time-consuming process of working out what its operational risks are and the extent to which those are covered under the insurance.

It would also need to work with its insurers on the terms of its insurance policies, to ensure that the coverage is strong enough to satisfy the regulator – areas for consideration include increasing the policy period or providing for a rolling period of coverage, providing a mechanism to replace insurers in the event of downgrade and reducing conditionality of the policy.

If the bank and the insurer are able to work together to agree these changes, then there are benefits to both sides. Financially, the bank may be able to obtain a substantial reduction in its regulatory capital and the insurer may be able to obtain an increase in premium.

More generally, the bank will end up with a more robust risk-transfer mechanism, while the insurer may secure business from a bank that might otherwise not have bought insurance at all.

IN 2004, the Basel II Accord was published by the Committee on Banking Supervision. This framework for international banking regulation focused on "operational" risks, meaning the risks of loss from inadequate or failed internal processes, systems or personnel and/or external events.

Operational risks include the risks of lawsuits, theft, loss of data and property destruction. Insurers are, of course, familiar with such risks and provide protection against them on a daily basis.

Basel II requires banks to set aside capital to protect against their operational risks. But if the banks also have insurance for those same risks, they can ask for a reduction in the amount of capital they have to set aside. The theory is, if they are already using protection (in the form of an insurance policy) then it may be unnecessary for them to have a second form of protection for the same risks.

Banks can use their insurance to claim a reduction of up to 20% of their capital risk charge. This is potentially a huge



Banking on insurance: insurers must be authorised to carry on insurance by an EU regulator or an equivalent

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