We’re here! A Willis practice devoted to financial institutions. Since joining Willis in June, I have concentrated on building awareness of the fantastic capabilities and resources that we offer financial institutions. Between traveling to meet with as many clients and old friends as possible, and working with our team internally, it has been a consistent goal to let you know just how strong and accomplished our team is, both in the United States and around the world. It is my hope that, in the next few months, I have the opportunity to get together with you to demonstrate our resolve and the value of Willis FI Practice product and service offerings.

The numerous segments that comprise the financial institution (FI) industry share many concerns, but also face distinct risk management issues. As such, the complex needs of FIs are often inadequately or incompletely addressed.

With the launch of a formal North American FI Practice, we are pleased to bring to the FI community the energy, spirit and focus of Willis – the world’s fastest growing broker – as well as the experience, creativity and thought leadership demanded by a rapidly evolving industry.

It is our goal to be considered a thought leader by our clients and colleagues. While a basic tenet of Willis’ overall service model, it is also core to our financial institutions service protocol.

As part of the intellectual capital we bring to the table, we are launching a series called FI Alert: brief issue-focused newsletters that provide the practical, thought-provoking depth of analysis that today’s FIs can’t do without. Our premier issue is on Basel II, which has the potential to have a wide impact on the banking world, and, in light of recent activity by our industry colleagues in Europe, an equally important effect on the way insurance plays into the larger financial universe. This piece is the result of a collaboration by members of our London and US-based FI team. Future issues will deal with topics such as cyber liability for financial institutions and alternative risk transfer methods. We trust you will find this series timely and informative. In addition, we welcome your feedback and suggestions for future topics.

— John Bayeux, FI Industry Practice Leader
Financial Institutions
Operational Risk Technical Update

**Basel II and Capital Adequacy Directive 3**

While it is not yet known when and if these requirements will be enacted for US financial institutions, it is important to note that on June 26 of this year, the Basel Committee on Banking Supervision published its “International Convergence of Capital Measurement and Capital Standards: A Revised Framework,” familiarly known as Basel II. On July 14, Brussels published its Directive “on the capital adequacy of investment firms and credit institutions.” Its enactment will give Basel II the force of law within the EU. In addition, subject to minor modifications, it will apply the new capital adequacy regulations not only to banks but to financial institutions generally within the EU. Implementation of Basel II is scheduled to take effect globally at the end of 2006, but with recognition of operational risk Advanced Measurement Approaches (AMA) not effective until the end of 2007.

Generally, as regards operational risk and insurance, there is little change between Basel’s third consultative paper (CP3), published June 2003 and the final Basel II document. However, following consultation with industry, certain parts of the Operational Risk portion (Section V, covering paragraphs 137-149) provide further explanation, including:

- Advice on how banks can manage issues arising from the running of operational risk programs subject to different national regulators – so-called “home/host” concerns

- Information on the gross income calculation for the Basic Indicator and Standardised Approach to operational risk measurement

- More stringent information requirements from banks on the weighting afforded different information sources of quantitative data in AMA Approaches (e.g., external loss data, internal loss data, and level of available data across different business lines)

For insurance practitioners, the Risk Mitigation section is particularly relevant. Some amendments have been made here and the following extract makes it clear that requirements may be subject to further change.

“The (Basel Supervisory) Committee intends to continue dialogue with the industry on the use of risk mitigants for operational risk and, in due course, may consider revising the criteria for and limits on the recognition of the operational risk mitigants on the basis of growing experience.”

– Basel Supervisory Committee, BIS, June 2004

The following table displays the changes to requirements (if any) between the draft document (CP3) and the final published Accord (Basel II), and possible implications for financial institutions.
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<tr>
<td>1</td>
<td>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 percent of the total operational risk capital charge.</td>
<td>(Same wording as CP3)</td>
<td>Despite lobbying for the wider recognition of insurance, mitigation will be limited to banks permitted to adopt an operational risk advanced measurement (AMA) approach. Banks will receive up to a maximum of 20 percent reduction to their operational risk capital charge subject to meeting certain criteria.</td>
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<td>2</td>
<td>The insurance provider has a minimum claims paying ability rating of A (or equivalent).</td>
<td>(Same wording as CP3)</td>
<td>This is accepted, and should not cause concern to our FI client base.</td>
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<td>3</td>
<td>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 percent haircut for those policies with a residual of 90 days or less.</td>
<td>(Same wording as CP3)</td>
<td>Willis would have expected a revision to this requirement at the national level following discussion with the UK FSA. Arguably an insurance policy has the same value to the insured regardless of the length of time the policy has to run. As this requirement stands, the ‘reducing’ value of the insurance must be factored into the capital allocation model.</td>
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<td>4</td>
<td>The insurance policy has a minimum notice period for cancellation and non-renewal of the contract.</td>
<td>The insurance policy has a minimum notice period for cancellation of 90 days.</td>
<td>Following the consultation phase, the minimum cancellation period has now been set at 90 days. The UK FSA state that an insurance policy with a minimum cancellation period less than 90 days automatically has a 100 percent haircut, and therefore no capital mitigation value (see point 3 above).</td>
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<td>5</td>
<td>The insurance policy has no exclusions or limitations based upon regulatory action or for the receiver or liquidator of a failed bank.</td>
<td>The insurance policy has no exclusions or limitations triggered by supervisory actions, or, in the case of a failed bank, that preclude the bank, receiver or liquidator from recovering for damages suffered or expenses incurred by the bank, except in the respect of events occurring after the initiation of receivership or liquidation proceedings in respect of the bank, providing that the insurance policy may exclude any fine, penalty or punitive damages resulting from supervisory action.</td>
<td>Following the consultation phase, Basel would have been advised that this draft requirement is unworkable. Therefore, the requirement has been limited to those losses occurring prior to the liquidation/receivership. By contrast, regulatory action is not permissible for cessation of insurance. This may require changes to the exclusion wording of insurance contract.</td>
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<td></td>
<td>Third Consultative Paper (CP3)</td>
<td>Final Document</td>
<td>The Changes/What This Means</td>
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<td>6</td>
<td>The insurance coverage has been explicitly mapped to the actual operational risk loss exposure of the institution.</td>
<td>The risk mitigation calculations must reflect the bank’s insurance coverage in a manner that is transparent in its relationship to, and consistent with, the actual likelihood and impact of loss used in the bank’s overall determination of its operational risk capital.</td>
<td>It is very difficult to map operational risk loss exposure to insurance policies and coverage. This has been realised by Basel and the requirement amended appropriately. Willis has the expertise to help financial institutions satisfy this requirement.</td>
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<td>7</td>
<td>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 reinsurance, that meets the eligibility criteria.</td>
<td>(Same wording as CP3)</td>
<td>Despite discussion with the UK FSA, the position on Captives remains unchanged. Captives are penalised. Not only will capital held within a Captive not count towards regulatory capital, but also insurance with a Captive will not benefit risk mitigation, except to the extent that the Captive is re-insured with an independent third party entity. Willis has the expertise to help financial institutions satisfy this requirement.</td>
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<td>8</td>
<td>The framework for recognizing insurance is well reasoned and documented.</td>
<td>(Same wording as CP3)</td>
<td>Willis has the expertise to help financial institutions satisfy this requirement.</td>
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<tr>
<td>9</td>
<td>The bank discloses the reduction of the operational risk capital charge due to insurance.</td>
<td>The bank discloses a description of its use of insurance for the purposes of mitigating operational risk.</td>
<td>This change requires FIs to disclose not only the percentage of capital reduction attributable to insurance but also the methodology adopted. Willis has the expertise to help financial institutions satisfy this requirement.</td>
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</table>
| 10 | The bank’s methodology for recognizing insurance under 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  
   • A policy’s cancellation and renewal terms  
   • The uncertainty of payment as well as mismatches in coverage of insurance policies | (Same wording as CP3) | See comments to point 3 above. |
Willis has been instrumental in providing advice and commentary on the Basel initiatives to industry participants and regulators since this process began, and remains committed to doing so both in the EU and the US. Experienced Willis Associates have been and will continue to provide consultation and assistance to Willis clients on this topic.

For further information on Basel II or related issues, contact:

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