



**Comments on CEBS Guidelines on Operational Risk  
Mitigation Techniques (CP n°25)  
issued on April 8, 2009**

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This response was prepared in reaction to this set of guidelines for risk mitigation recognition, issued by CEBS. It includes propositions on some issues where we believe some more prescription is needed from regulators. This response follows a former answer (in annex to this paper) to CP 21 on the “insurance use test” of operational risk.

Some issues have been made clearer by CEBS in this Consultative Paper n°25. Indeed, the insurer’s rating (paragraph 21) and the cancellation clauses (paragraph 20) could have been understood, initially, as eligibility criteria for an insurance policy, whereas they are now clearly haircut issues.

Haircuts are the topic of our paper. Indeed, while insurance contract eligibility has been for long the only major issue for the industry (bankers requesting adapted contracts from insurers), banks have now to assess the haircut, i.e. the risk mitigation value of these contracts. That represents a deep work, requiring them to challenge the quality of their own risk data and organization. Regulators could be more prescriptive on haircuts than mentioned in paragraph 21, and we provide below some ideas in this field :

- Focus on severity risk :

Insurance rarely matches the Basel 2 risk categories, and major severity operational risk scenarios do not match those categories either. As scenarios are the basis for the calculation of 80 % of the regulatory capital, then an insurance coverage percentage number stemming from an internal loss data base (as mentioned in the paragraph 21 of this CP) may give too few, or biased, indications on the haircut.

Regulators should expect insurance impact to be integrated in severity scenarios. We support the CEBS recommendation (paragraph 14) that the insurance mapping exercise should be performed with sufficient granularity, however this granularity should concern the mapping of insurance to the potential severity events. That is all the difference between a statistical work on past payouts and a much richer work on potential events, requiring to have understood both the risk event and the insurance policy.



- Address separately each type of insurance :

When assessing the haircut, or the reasonable claim payment delay, insurance looks simpler if we consider that there are roughly 3 types of insurance contracts purchased by a bank, each requiring a specific treatment :

- Property policies : cover first party loss and (except in some IT or business interruption issues) should not bear any payment delay, nor major haircut
- Crime policies cover also the insured's first party loss (that can be a credit loss) and their payment delay can be framed within a specific protocol
- Liability policies, covering Third Party damage, with claims treatment often exceeding one year, are a separate topic for discussion. Their status as a risk mitigant should be considered scenario per scenario.

As a conclusion, insurance is not only about risk transfer, it is a risk management tool. If regulators agree on the fact that this long lasting practice of having an insurer covering part of the risk is a good risk management practice, then they should come back and consider the proposition made by the European Commission in 2003, eventually withdrawn for haircut calculation issues, to incentivize Standard Banks to purchase insurance.

Haircuts can lean on simple insurance scoring products, assessing the performance of the insurance policy in mitigating a specific risk profile. Those products already exist and can be used by the industry in this perspective.

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**ANNEX : Comment on CEBS Compendium of Supplementary Guidelines on implementation issues of operational risk (CP 21 on use test, issued on December 19, 2008)**

**Introduction**

We have prepared this formal response to draw attention to the fact that there is one key area where we believe the proposed CEBS Compendium of Supplementary Guidelines on implementation issues of operational risk, issued on December 19, 2008 may be insufficient. This area is the management of the bank's insurance program, which we believe is a key use test of its operational risk framework.

We understand, from the footnote n°2, page 2 of this document, that insurance should be addressed by CEBS in a future consultation paper. We agree upon the need for deeper investigation to solve the problem of assessing the value of the insurance coverage in the capital calculation. We believe however, as was mentioned during the CEBS industry hearings held in January 2008, that the insurance decision process itself should be considered by banks as a use test of their operational risk model, and should not be treated by regulators, as we understand from the absence of any mention of insurance in these latest CEBS guidelines, separately from other use test or risk management best practices considerations.

To this aim, we have chosen to briefly explain, in this answer to CEBS :

How insurance management proves to be one of the most efficient and “ready to use” tests of the operational risk data and organization in a bank

Why there is no valid reason left today for not embedding the insurance management in the operational risk management within the banking organizations

In which way the permanence of this artificial division, in the regulatory papers, between risk and insurance, does not contribute to the principal objective of Basel 2, which is to encourage risk management best practices.



## **An efficient use test**

We believe insurance management is one of the most immediate and efficient use tests for the following reasons : (a) it addresses major areas of operational risk, (b) it involves the contribution of a major third party actor, (c) it involves major financial decisions from the Senior Management, (d) it proves to be a very practical risk management tool.

*(a) 50 to 70 % of severity risk events could be addressed by one or more insurance products*

Obviously, insurance products are not involved in 100 % of the operational risk area, but studies have shown that (without any consideration of amount) it addresses a proportion ranging from 50 to 100 % of risk events in such areas like fraud, physical damage, and fiduciary issues. In other parts of operational risk, its impact ranges between 0 and 50 %, but we can estimate that, overall, if we limit ourselves to severity risk events, 50 to 70 % of them could, at least partly, be addressed by one or more insurance products.

*(b) The insurance company is the only third party betting on the efficiency of the risk management of the bank it covers*

Thus, insurance companies have strong incentives to support the risk management of their insured clients, for instance :

- We have examples of decisive interventions performed by insurance experts in the fire prevention and workplace safety areas.
- Unauthorized trading insurance policies, at the time some of them were put in place, were accompanied by external due diligences, which may have prevented the occurrence of some recent cases.

We also believe that some events like a major insurer escaping from a policy renewal (or renewing its participation for an excessive premium increase), are early risk indicators that should be taken into account by stakeholders, among which banking regulators, for it generally demonstrates that the insurer is perceiving an deterioration of its risk.

*(c) Insurance is a major financial decision made by the Senior Management*

Each year, Senior Managers of large banks take decisions involving insurance expenses often exceeding ten million Euros. Some firms, actually a minority, have



succeeded in aligning some of their coverage decision on their own operational risk profile, i.e. :

- Their insurance deductibles are computed from their own loss data base
- Their limits of guarantee match their severity scenarios
- The policy wording chosen corresponds to their risk map.

When signing up their insurance policies, Senior Managers of those firms have a clearer idea of what is covered and, more important, of the exact nature of the retained risk, which is a guarantee of the involvement of these managers.

*(d) The internal allocation of the insurance premium is a “ready to use”, commonly accepted, risk management tool*

Operational risk capital allocation process, which, as was witnessed in 2008 in the wake of the Société Générale case, can generate brutal methodological adjustments, is sometimes perceived as opaque by business units. On the other hand, the insurance premium internal allocation exercise, when properly aligned on the insurable operational risk profile of each business unit, proves to be an efficient incentive for risk management, as this is a cash and understandable scheme, then more favorably received by business units.

Although there is no recognition of them in pillar 1, (re)insurance captive companies are often efficient operational risk management tools.

### **Why such a dividing wall between risk and insurance ?**

Experience proves that the absence of a satisfying link between risk profile and coverage, which reflects the majority of the situations encountered so far, is explained by :

A lack of confidence in the risk data : when it comes to use their risk scenarios and loss data bases for insurance purposes, firms often find this data not “comprehensive, consistent or granular enough”... but amazingly good enough to calculate an AMA capital

The discrepancies existing between both insurance and operational risk domains make this bridging process uneasy. Indeed insured areas rarely match with the Basel 2 risk categories, and more generally the insurance language largely differs from the banking



language. But bridging methodologies are available and we continue to believe that benefits obtained by linking both concepts largely exceed allocated resources.

The fact that insurance is too often considered as a mere risk transfer product, forgetting its contribution to the day to day risk management at every level of the bank. This limited view is the main reason why insurance guidelines issuance has been put at the very end of the AMA pillar 1 agenda. But when it comes to assess, at last, the actual value of insurance in the capital model, firms will discover that the insurance mapping task should have been carried out by them long before.

### **The danger of another artificial slicing of risk management :**

As we have said, this artificial dividing line between what appears, in some banks, to be two separate operational risk management organizations (the operational risk management itself and the insurable risk management), if not properly pointed at by regulators, leads to missed opportunities in the fields of risk management as well as premium expenses optimization.

Furthermore, on a larger scale, we fear that introducing another artificial slicing in the risk management area is counterproductive in the Basel 2 perspective of enhancing risk management organizations in banks. We have indeed witnessed, during the latest months, that some artificial borders set up by the Basel regulation, and mirrored by banks in their own organization charts, have been harmful for the banking industry :

- Large US banks have recognized that market and credit risk separation have been instrumental to their excessive positions taken on structured credit products
- ... and that harmonized credit and operational risk management organizations could have prevented them to grant such amounts of fraudulent mortgages in 2006 and 2007
- It also appears that artificial borders between operational, market and credit risk controls have been actively used by rogue traders in recent cases
- Operational and market risk border could also prove to be counterproductive when it comes to assess the capital allocation of asset management companies bearing more and more fiduciary risk, itself largely correlated to the market risk carried by investors via the product they have purchased.
- Etc...



We recommend then to avoid encouraging practices leading to or maintaining another artificial division inside risk management organizations, and to support those management practices in banks that embed insurance in operational risk management.

An explicit inclusion of insurance management in the supervisory guidelines on use test requirements and operational risk management best practices would be a strong sign towards this direction.