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Guidelines on operational risk mitigation techniques, CP25, unofficial Febelfin comment

Brussels, 13/07/2009,

Dear Madam,

Febelfin, i.e. the Federation which regroups four trade associations from the Belgian financial industry¹, welcomes the opportunity to express its views on the consultation document mentioned above. We send you our comments in an unofficial way, as they still have to be evaluated by the Febelfin Board.

In a context where overall capital requirements for banks are strongly increasing, we are quite worried by the theoretical level of the guidelines for operational risk mitigation, in particular for the use of insurance as risk mitigation. **We advocate that the regulatory framework for operational risk mitigation should at a minimum be applicable in practice.** In other words, conditions for its application should be in line with market practices, in this case, with the practices in the insurance sector.

We acknowledge that some issues are part of European and international prudential regulatory framework, but are convinced this should not be an obstacle. With the European and international prudential regulation under review in response to the financial crisis, a new balance is to be found between capital measures on the one hand and the possibilities for mitigation of those capital measures on the other hand.

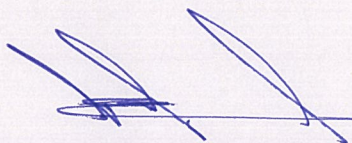
For this reason we propose that the guidelines can be reviewed concerning:

- a) The initial term of insurance policies;
- b) The claims paying ability rating of insurance companies;
- c) The use of captives as independent third parties for insurance provision.

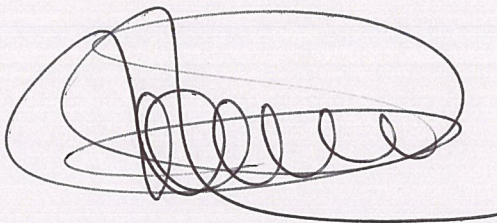
¹ The following trade associations are part of Febelfin: the Belgian Bankers' and Stockbroking Firms' Association (ABB/BVB); the Professional Union of Credit Providers (UPC/BVK); the Belgian Asset Management Association (BFAMA); the Belgian Leasing Association (BLA).

Finally, we would like to thank the CEBS-secretariat for granting us a prolongation to the consultation period.

We hope these remarks will be taken into account. Please do not hesitate to contact our services and our working group, should you want any further information.



Michel Vermaerke
Chief Executive Officer



Daniel Mareels
Director Taxation & Prudential, Legal & Compliance

Cc. Mr Jean-Paul Servais, Chairman, Banking, Finance and Insurance Commission

Guidelines on operational risk mitigation techniques, CP 25, unofficial Febelfin comment, annex

- **Conditions for the use of insurance as risk mitigant should be in line with market practices:** As we mentioned in our letter of 21st February 2006 responding to CP10 Rev, we are of the opinion that the use of insurance as a risk mitigant should stay in line with current market practices. **In other words, regulation should not be theoretical.**

Annex X, paragraphs 27 a) and b) of the CRD stipulate the following:

- a) 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 credit institution 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;
- b) the insurance policy has a minimum notice period for cancellation of the contract of 90 days

Finding insurance policies with an initial terms longer than one year is now, more than ever, a challenge, especially in particular areas such as coverage for 'professional liability and fraud' and 'Director and Officers insurance policies'. But **this trend is spreading to all lines of operational risks.**

We acknowledge that some insurance providers construct two-year policies that comprise a standard one-year policy with the option to purchase, at the end of that year, an additional year. This is done at hefty premiums which amount to 300% of the initial premium. While it should be left to each individual institution to judge whether one is prepared to accept such conditions, we believe that a more fundamental issue is to be addressed by CEBS.

About the haircut applicable, the question remains if this haircut would be gradually applied through the first 9 months of the policy period, ending at a zero level 90 days prior renewal (decline rate around 11% a month) ; or if the haircut is not applied except if, 90 days before renewal, instructions has still not been given to renew the policy.

We also advocate that the regulatory framework for operational risk mitigation should at a minimum be applicable in practice. In other words, conditions for its application should be in line with market practices, in this case, with the practices in the insurance sector.

- **Claims paying ability rating of A:** Paragraph 678, first bullet of the Basel II Framework states that institutions can only take insurance as a risk mitigant into account under AMA when the insurance provider has a minimum claims paying ability rating of A (or equivalent).

The CRD is less stringent in its Annex X, paragraph 26 by requiring that the insurance provider has to have a minimum claims paying ability rating by an eligible ECAI which has been determined by the competent authority to be associated with credit quality step 3 or above under the rules for the risk weighting of exposures to credit institutions under Articles 78 to 83.

Proposal: use a claims paying ability rating of A minus as very little insurance providers in the world still have an A rating.

- **Independent third party for insurance provision:** Annex X, paragraph 27 e) of the CRD requires that 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 a re-insurer that meets the eligibility criteria.

While the Directive does not exclude the use of captives and affiliates, we are worried that CP 25 seems to suggest in its paragraph 15 a more restrictive approach.

We do not support such a restrictive approach and advocate that institutions receive the possibility, on a case to case basis, to explain to the regulator why the use of a captive should be permitted. The regulator then can assess this proposal taking into account several factors which are to be defined by CEBS. As such we do not defend a 'blind' acceptance of captives as independent third parties, but are of the opinion that under certain conditions their use can be permitted.

As a consequence, we defend that CEBS can take into account the use of captives and affiliates as independent third parties for insurance provision under AMA. The assessment should be done on a case by case basis taking into account conditions which are to be defined at European or international level in order to ensure a level playing field.