Committee of European Banking Supervisors

CEBS

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GUIDELINES ON OPERATIONAL RISK MITIGATION TECHNIQUES

1. Introduction

1. Institutions can employ a variety of risk transfer instruments to manage and mitigate their operational risk. These take the form of insurance contracts and "Other Risk Transfer Mechanisms" (ORTM). The Capital Requirements Directive (CRD) allows institutions that use the AMA to recognise the mitigating effect of these instruments in their AMA capital calculations, subject to certain conditions.

2. The conditions that apply to insurance providers and contracts are set out in Annex X, Part 3, Paragraphs 26 to 29 of the CRD[1]. As for ORTM, Annex X, Part 3, Paragraph 25 of the CRD states that the impact of ORTM shall be recognised only if the institution can demonstrate to the satisfaction of the competent authorities that a noticeable risk mitigation effect is achieved.

3. The Guidelines on the Implementation, Validation and Assessment of AMA and IRB Approaches (the "Validation Guidelines"), issued by CEBS in April 2006, provide only limited additional guidance on these instruments for transferring operational risk. In particular, Paragraph 578 of the Guidelines states that the Supervisory authorities expect an appropriate level of standards for the recognition of ORTM, while Paragraph 579 states that outsourced activities should not be considered part of ORTM.

4. The main objective of this paper is to provide more complete guidance on the recognition of insurance within the AMA capital calculation. In particular, after addressing in Section 2 general conditions for the recognition of operational risk mitigation instruments, Section 3.1 deals with the eligibility of protection providers and the characteristics of eligible

[1] Except where noted otherwise, all references to Articles and Annexes of the CRD are references to Directive 2006/48/EC.

products and Section 3.2 covers the issue of haircuts for uncertainty in coverage.

5. The treatment of ORTM is discussed in Section 4. For several reasons - the most important being the relatively brief experience of institutions and supervisors with this type of protection – CEBS has decided to issue only a limited number of specific guidelines at this stage, and to refer instead, as a general rule, to CRD requirements and CEBS guidelines for insurance, and to relevant sections of the CRD framework for credit risk mitigation (in particular, Part 1, "Eligibility", and Part 2, "Minimum Requirements", of Annex VIII of the CRD). Supervisors should bear in mind, however, that stricter conditions could be necessary for the recognition of ORTM within the AMA framework, reflecting differences in the type of protection provided by these instruments as compared with insurance contracts, and the peculiarities of operational risk relative to credit risk.

6. Finally, institutions and supervisors should keep in mind that – depending on how the ORTM are structured and how they are classified in the institution's accounts – they can entail additional risks (such as credit risk and market risk) for the institution buying or selling protection, and that these carry regulatory capital implications of their own.

7. CEBS will continue its dialogue with the industry on the development of ORTM and will closely monitor their use as instruments for operational risk mitigation. As institutions and supervisors gain more knowledge and experience with these instruments and a range of best practices is identified, CEBS will supplement and/or review these guidelines, and may also recommend adjustments in the pertinent regulatory requirements under the CRD framework.

2. General conditions for risk mitigation techniques

8. Annex X, Part 3, Paragraph 29 of the CRD states that "the capital alleviation arising from the recognition of insurance shall not exceed 20% of the capital requirement for operational risk before the recognition of risk mitigation techniques". While the wording of this paragraph mentions only "insurance", CEBS does not believe that the legislative intent was to exclude ORTM from the scope of the 20% limit. This interpretation is supported by an amendment to the CRD which is currently being considered under the Comitology procedure. Taking into consideration the original intent of the regulatory framework, and bearing in mind that the proposed changes to the CRD will be applicable from year-end 2010, supervisors should apply the 20% limit on capital alleviation to both insurance contracts and ORTM, which together should not exceed the 20% limit.

9. Paragraph 580 of the Validation Guidelines states that institutions should review their use of insurance and ORTM and recalculate the operational risk capital charge if the nature of insurance or the coverage of ORTM changes significantly. If a material loss is incurred which affects insurance coverage,

or if changes in insurance or ORTM contracts create major uncertainty as to their coverage, institutions should recalculate the AMA capital requirement with an additional margin of conservatism, for example by applying haircuts in the modelling exercise. The AMA capital requirement should also be recalculated if there is a major change in the operational risk profile of the institution.

10. Paragraph 581 of the Validation Guidelines requires institutions to notify competent authorities of material changes in the coverage of insurance or ORTM. Supervisors will closely monitor the features of insurance products and ORTM and their impact on the coverage of operational risk.

3. Specific conditions for the use of insurance

3.1. Eligibility of providers and characteristics of the products

11. According to Annex X, Part 3, Paragraph 26 of the CRD, in order for insurance to be recognised for capital purposes, the insurance provider must be authorised by a regulator to provide insurance contracts or re-insurance contracts. The EU "single passport" provides an explicit mechanism for mutual recognition of EU-regulated undertakings, enabling an EU Member State to accept the authorisation granted by another EU Member State without itself having to verify that the undertaking is appropriately authorised. However, consideration should be given to the recognising the risk-mitigating effect of insurance contracts provided by an undertaking authorised by a non-EU regulator, if that undertaking satisfies prudential requirements that are equivalent to those applied in the EU and meets the standards set in Paragraphs 26 to 29[2].

12. The Basel II regulatory framework allows banks to recognise the risk-mitigating impact of insurance if the insurer has a minimum claims-paying ability rating of A (or equivalent). However, the CRD sets a less stringent standard. Paragraph 26 requires insurers to have a "minimum claims paying ability rating by an eligible ECAI which has been determined by the competent authority to be associated with a credit quality step 3 or above under the rules for the risk weighting of exposures to credit institutions under Articles 78 to 83". EU supervisors are governed by the CRD, and should therefore allow ratings equivalent to credit quality step 3 or better [3], based on the long-term claims-paying ability rating of the insurer.

13. Paragraph 27(a) requires that insurance contracts must have an initial term of no less than one year. This should be interpreted as requiring the parties

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[2] All references to Paragraphs 26 through 29 in these Guidelines refer to Annex X, Part 3 of Directive 2006/48/EC.

[3] This view is supported by the response of the CRD Transposition Group (CRDTG) to question n. 95, published in August 2006.

to contract for at least one year. The "residual term" should refer to the period remaining on the contract at a given point in time.

14. Paragraph 27(d) states "that the risk mitigation calculations must reflect the 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 overall determination of operational risk capital." The mapping of insurance contracts to potential operational risk losses (or operational risk sub-categories) should be performed at a sufficiently granular level to demonstrate the relationship between the actual likelihood and magnitude of operational risk losses and the level of insurance coverage. Calculations should reflect the level of coverage, for example through the determination of a probability of coverage.

15. Paragraph 27(e) states that insurance may be recognised for capital purposes only if it is provided by a third-party entity, i.e. an independent entity outside the group of the institution seeking insurance protection. When making this assessment, supervisors should have a complete grasp of the institution's group structure so as to be able to assess whether the operational risk has in fact been transferred outside the group to an entity in which neither the institution nor any other entities within its group has a relevant interest. In analysing the group structure, supervisors should consider the group definitions given by the CRD, national financial services Acts, and corporate group law (where applicable). An institution should also take reasonable steps to ensure that neither it nor any of its subsidiaries is knowingly re-insuring contracts that cover operational risk events that were the object of the initial insurance arrangement entered into by the institution.

3.2. Haircuts for uncertainty of coverage

16. Institutions that use insurance instruments to transfer operational risk should analyse the various factors that create uncertainty in the effectiveness of the risk transfer. They should reflect these uncertainties in their capital calculations through appropriate haircuts.

17. Haircuts should be calculated conservatively. It is up to each institution to determine the appropriateness of the haircuts it applies. The CRD provides little detail on how haircuts should be applied, leaving institutions with considerable discretion to develop methods that suit their structure. Supervisors should assess these haircuts carefully, balancing the discretion provided by the CRD against the need to ensure that the general intent of the rules is not circumvented.

18. The following parts introduce guidelines on haircuts for insurance coverage, distinguishing them on the basis of the pertinent elements of uncertainty, namely: maturity, cancellation and uncertainty of payment and mismatches in coverage.

a) <u>Maturity</u>

19. Paragraph 27(a)[4] requires institutions with insurance contracts that have less than a year to run, to apply appropriate haircuts reflecting the declining residual term of the policy. Supervisors may waive this requirement if the institution has in place a replacement contract that provides insurance cover on equivalent terms or if the current insurance contract has an automatic renewal provision and no cancellation notice has been given[5]. However, institutions and supervisors need to be cautious about assuming that institutions can renew their policies on equivalent terms, conditions, and coverage, as some risks covered by the policy may not be re-offered when the policy is renewed [6] .

b) Cancellation

20. Paragraph 28(b) requires institutions to capture policy cancellation terms, where less one year, through haircuts. In some jurisdictions, national insurance regulations or national law grants insurance providers the right to cancel insurance policies. In the case of renewable policies, the renewal assumptions should also take into account the ability of the insurer to cancel the policy during the term or at the renewal date.

c) Payment uncertainty and coverage mismatches

21. Paragraph 28(c) requires institutions to apply haircuts for payment uncertainty and for mismatches in the coverage of insurance policies.

- Payment uncertainty is the risk that the insurance provider will not make the payments expected by the institution in a timely fashion. This can result, for example, from differences in the interpretation of contractual language, from counterparty default (insurers with a lower claims-paying ability should attract a higher haircut), or from unanticipated delays in payment (for example, arising from the claims protocol or the evaluation and settlement processes). Institutions, if necessary, should consider and fully document data on insurance payouts by loss type in their loss databases, and set haircuts accordingly. Supervisors should also familiarise themselves with customary claims payment delays, which can often exceed one year.

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[4] As noted earlier, all references to Paragraphs 26 through 29 in these Guidelines refer to Annex X, Part 3 of Directive 2006/48/EC.

[5] For example, if an insurance contract for two or more years has a clause providing that the parties will negotiate a new two-or-more-year contract before the expiry of the first year, the contract revolves every year, ensuring that there is always at least one year outstanding on the contract. If in addition the coverage of the policy does not change with renewal, a haircut needs not to be applied.

[6] For example, the insurer may retain the right to increase the premium, and there is the risk that the premium may be increased to an unacceptably high level if there is a significant loss by the institution (or the industry) which prompts the insurer to revise its pricing. Furthermore, insurers may decide to cease writing business for certain types of risks, as the result of high losses or other industry or legal developments.

- A coverage mismatch occurs when the coverage of the insurance contract coverage does not match the operational risk profile of the institution, such that the cover does not provide the desired mitigating effect.

4. Specific conditions for the use of ORTM

22. Paragraph 25 states that ORTM may be recognised for capital purposes only if the institution can demonstrate to the satisfaction of its competent authority that it achieves a noticeable risk mitigating effect. Supervisors expect buyers of ORTM protection for which capital alleviation is claimed to use such instruments for risk management, and should not accept ORTM as risk mitigants under the AMA framework if they are held or used for trading purposes. Supervisors should monitor the use of such products closely and assess the intent of the institution in purchasing such instruments when evaluating their risk mitigating effect.

23. Institutions should have experience in using ORTM products before they can recognise these products in their AMA capital calculations. This requirement is intended to encourage institutions to collect data from internal and external sources on the probability of coverage and the timeliness of payment for ORTM instruments. This is particularly essential for product types or classes with novel characteristics, and is not necessarily required for every product.

24. While ORTM reduces the operational risk exposure of the protection buyer, it increases the risk exposure of the protection seller. It is essential that the protection seller should be financially sound, both in terms of solvency and of liquidity. Supervisors should be aware of the risks assumed by sellers of ORTM protection, and should consider prudential measures if a protection seller acquires significant risk exposures from other institutions. Consideration should be given also to the possibility that the seller of some forms of ORTM protection may be subject to insurance regulation under national insurance regulations.

25. Supervisors should assess the institution's use of ORTM in AMA capital calculations on a case by case basis, considering the eligibility of the protection seller (regulated or unregulated entity) and the nature and characteristics of the protection provided (funded protection, securitisation, guarantee mechanism, or derivatives).

26. Such assessments should be based on the relevant requirements of Paragraphs 26 to 28 and the specific conditions set out in Section 3 of the present Guidelines. Supervisors should also take into consideration relevant sections of the requirements for recognition of credit risk mitigation in Part 1 ("Eligibility") and Part 2 ("Minimum Requirements") of Annex VIII of the CRD.

27. When considering these requirements and conditions, supervisors should bear in mind that stricter qualifying criteria may be required concerning the eligibility of ORTM providers and the type of ORTM products for the following reasons:

- The peculiarities of operational risk relative to credit risk (e.g., absence of underlying assets, greater role of unexpected losses);
- The lack of an efficient, liquid, and structured market for analogous products which thus far have been traded outside the banking sector (e.g., catastrophe bonds, weather derivatives);
- The difficulty in assessing the legal risk of ORTM, even when the terms and conditions of the contracts are clearly and carefully spelled out.