Operational Risk Management

Why Should Insurers Be Different?

Hansruedi Schütter

Baku, 20 June 2014

Banks top complaints league table

Customers made 2.5 million complaints against financial companies in the second half of 2013, with the biggest banks receiving thousands of calls and emails a day from disgruntled consumers.

Barclays topped the list, racking up 309,494 new complaints over the six-month period, which equates to 1,695 a day. Lloyds Bank came second, receiving 256,656 complaints, while Bank of Scotland and National Westminster also feature in the top five complained-about firms.

But complaints about financial firms on the whole have fallen by 15pc, figures from the Financial Conduct Authority (FCA) show. In the first half of 2012 a total of 2.9 million complaints were made.

The reason for the fall is a heavy decline in the number of complaints about the mis-selling of payment protection insurance (PPI). A total of 1.4 million PPI complaints were made, a fall of 22pc on the previous six months. But PPI still accounted for 56pc of all complaints.

The Telegraph

9 April 2014

Bank of England warns it will hold insurers to account

The Bank of England's governor has warned insurers the Bank will hold them to account for "reckless misconduct" in the same way it regulates the banks.

Writing in The Times newspaper, Mark Carney said: "Integrity, honesty and skill are not optional" whatever type of financial institution you run.

Insurers largely escaped the losses suffered by the financial sector in the wake of the crisis of 2008.

But he said they faced "challenges in the post-crisis landscape."

He suggested that the current era of low interest rates could lead to insurance companies taking higher risks to generate better returns.

While he admitted this was not necessarily a problem at the moment he said: "If we think that managements' actions today pose a risk tomorrow we won't hesitate to step in."

He also said the role of the Bank was to "make sure that failing insurers don't harm their policy holders, cost the taxpayer money or make insurance harder to obtain".

BBC NEWS

22 May 2014

The nature of different risks

Risk	Purpose	Manageability
Strategy risk	Make money	Medium, high
Business risk	Make money	Medium
Actuarial risk	Make money	High
Market risk	Make money	High
Credit risk	Make money	High
Operational risk	Protect earnings	Medium
Reputation risk	Protect sustainable earnings	Difficult

Operational failures? – Peanuts

- Common thinking is that operational risk will never account for more than 20% of any financial institution's regulatory capital / reserve requirements.

Operational Risk

a.k.a.
Cinderella Risk

And anyway...

- ... insurance companies have no operational risk – it's all actuarial
  (Quote from a European insurance CRO whose identity shall be protected here)

- *Just because Solvency II does not treat OpRisk in as much detail as Basel II, does not mean it is not there or can be neglected*

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Example: OpRisk at ING Australia

- ING Insurance : Australia's 2nd largest fraud
  - 40 year-old Rajina Subramaniam worked for ING Insurance in Sydney for 20 years as an accountant.
  - Embezzled AUD 45,000,000 between 2004 and 2010 by transferring suspense account balances and unclaimed client money to personal accounts.
  - Became known throughout Sydney for her lunch-hour shopping spree's – in 2009 alone:
    - Chanel (AUD 98,452)
    - Bulgari (AUD 3,300,000)
    - Paspaley – a jeweller (AUD 7,600,000, over and above AUD 16,000,000 in previous years)
  - Also bought 7 properties in her maiden name.
  - Reason for the fraud: not valued or respected, manager delegated everything to her

Example: Loss of data / disclosure

Event Details			
Title	Zurich in breach of Data Protection Act		
Description	Zurich Insurance has been obliged to sign an undertaking with the Information Commissioner's Office (ICO) agreeing to improve security. The insurer lost an unencrypted back-up tape containing personal financial information belonging to over 46,000 of its policyholders, and has been found breach of the Data Protection Act. Customers of Zurich Private Client, Zurich Special Risk and Zurich Business Client were affected by the slip-up. The tape, which also held details of 1,800 third parties, was lost by Zurich Insurance Company South Africa in 2008, during a routine transfer to a data storage centre. However, parent company Zurich Insurance plc was not informed of events for over a year. Subsequent internal investigations in South Africa revealed failings in the management of security procedures and under the terms of the Undertaking, future movement of the group's back-up tapes will require various data security measures, including the use of encryption. In addition, potential or actual data loss will need to be reported promptly. Earlier this month, Royal London was rapped over the knuckles by the ICO after eight of the mutual's laptops, two of which contained details of 2,135 people who had sought pension scheme illustrations, were stolen from its Edinburgh offices. The data were password protected but unencrypted.		
Event date	25/03/2010	**Source**	Insurance Daily (www.insurancedaily.co.uk)
Source article URL	www.insurancedaily.co.uk		
Country	South Africa	**Amount**	0.00 ZAR
Involved entities	Zurich Insurance; Royal London		
Industry type	Insurance	**Business line**	General Insurance

Example: Broker fraud

Event Details

Title	Judgement in broker's fraud case		
Description	Judgment began on Monday in the Cape Town trial of a former Old Mutual financial broker alleged to have embezzled 11 medical doctors. Francois Hendrik du Plessis, 42, of the Strand, has pleaded not guilty in the Bellville Specialised Commercial Crime Court to 76 counts of fraud, 12 violations of the Financial Advisory and Intermediary Services Act, five of money-laundering and one of forgery. With him in the dock is Elmarie von Willigh, 48, who has pleaded not guilty to 70 counts of fraud, five of money laundering and one of forgery. One of the medical practitioners who allegedly fell victim to the embezzlements is Dr Abdurehmam Kaskar. He was persuaded by Du Plessis to invest R135,000 in shares with the company APMI Holdings. Prosecutor Denzyl Combrinck alleges that Du Plessis, instead of investing the money, used it for himself. Du Plessis apparently falsely informed Sanlam that Dr Horst Kirsten had authorised him to withdraw R124,024 from an endowment policy, for investment purposes. Combrinck alleges Du Plessis was not authorised to make the withdrawal. On another charge, Combrinck alleges Du Plessis persuaded Dr Mireille Landman to invest R40,000 in shares with APMI Holdings, and that Du Plessis used the money for himself. According to the charge sheet, Von Willigh was a director of the company Capital Commitments, and had all the files pertaining to Du Plessis' clients in her possession. Similarly, Dr Richard Maske was allegedly persuaded to invest R100,000 in shares, but the money was used for Du Plessis' own personal benefit. Combrinck alleges Dr Rabia Patel was duped into making a non-existent share investment worth R488,902. Other doctors who allegedly fell victim to the alleged scam were Wopke van Hoorn, Marthinus Zeeman, Johannes Rossouw, Barny Kahanowitz, Hugh Casserley and Charles Matthews		
Event date	24/10/2011	**Source**	Independent Online (www.iol.co.za)
Source article URL	http://www.iol.co.za/news/crime-courts/judgement-in-broker-s-fraud-case-1.1163699		
Country	South Africa	**Amount**	880,000.00 ZAR
Involved entities	Old Mutual; Sanlam		
Industry type	Insurance	**Business line**	Life Assurance

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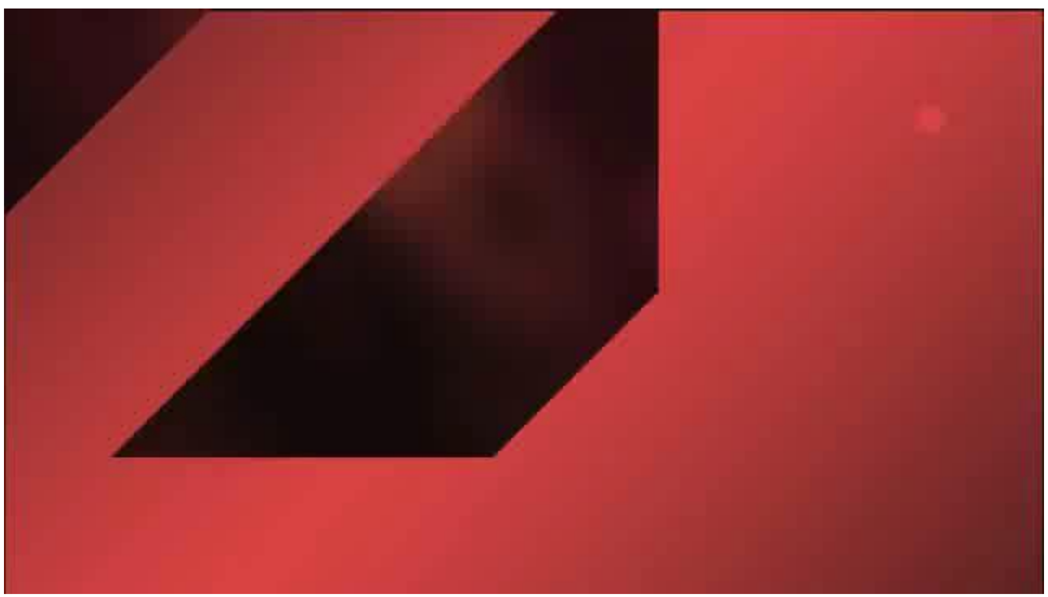
Can you name a firm which…..

- Failed due to a single market risk event?
- Failed due to a single credit risk event?
- Failed due to a single liquidity risk event?
- Failed due to a single reputational risk event?
- Failed due to a single operational risk event?



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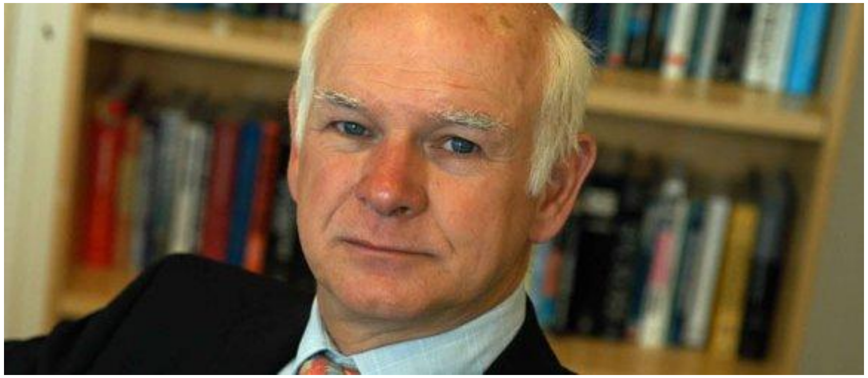
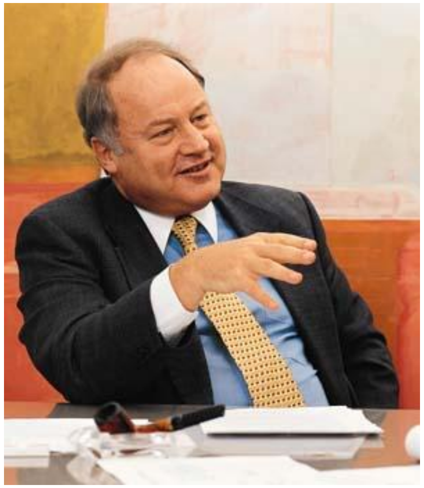
The big misconception

- Reserve requirements are a regulatory tool to assess the company's financial health.
- Reserves do not say anything about the company's management.





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The big misconception

“It is more relevant to understand and manage operational risk than to put a regulatory value to it.”

Dr. Hans-Ulrich Doerig, former Chairman,
then CRO, Credit Suisse Group

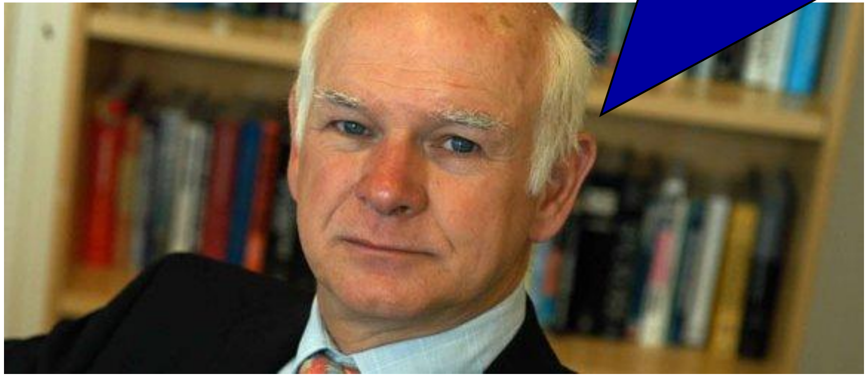
The RMA Journal, February 2001

The big misconception

"Capital is part of the regulatory tool kit, but only a small part. For most problems, capital is not our preferred response"

Howard Davies, then Chairman, FSA

Basel Capital Accord Conference, 10th April 2001



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The big misconception

Will common sense triumph over mathematics? Senior management must engage properly in assessing risks. They cannot treat models as a black box and rely unthinkingly on their outputs. This is why any firm applying to us for approval to use its own models must convince us that senior management understand the outputs and the limitations of models.

John Tiner, then Chief Executive, FSA
FT Bankers Awards, 6th September 2005

Too big to fail?

- January 2001: 7th largest US company, Leader in the energy sector
- December 2001: Enron filed for bankruptcy

- Poor financial reporting, accounting loopholes used to hide losses
- Inside trading
- Market manipulation

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All about data

- Yes, it is all about data !
- Data are needed to manage
- The things you see are the easiest to manage
  - RCSA data create risk awareness
  - Risk indicators provide trends and show exceptions
  - Loss data provide a validation for KRIs
  - Loss data further show risks misjudged in the RCSA
  - Indicator and loss data provide input for scenarios

The Risk*Business* Op*Risk Intelli*Set enables all sort of data collection and aggregation at every level of the organization, thus enabling managers at all levels to exert maximum control over the risks in their daily as well as their medium term business.

Focus on loss data

Charles Taylor, Office of the Comptroller of the Currency
then: The Risk Management Association

Taylor's message

- It's the low frequency / high severity events we should focus on
- Unpredictable does not mean unmanageable
- Look at related yellow indicators to identify an implicit red flag

From simple to composite KRIs

- Simple indicators may be useful for lower and middle managers in their daily work

- Senior managers needs a broader picture that simple indicators cannot provide
- Composite indicators made up of various components that influence or correlate with each other may provide that broader picture.

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Senior management focus

- Are many small things going slightly wrong in one area or in related areas?
- Are things going gravely wrong in any (unrelated but similar) area?

Basic distinctions

- Related indicators reflect factors that compound one another in their influence on a common underlying risk
  - e.g.: staff turnover and training
- Unrelated indicators reflect factors that do not impact one another
  - e.g.: staff turnover in London and staff turnover in New York

 Source: Charles Taylor, RMA

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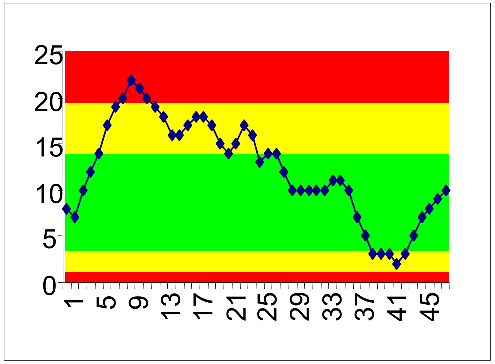
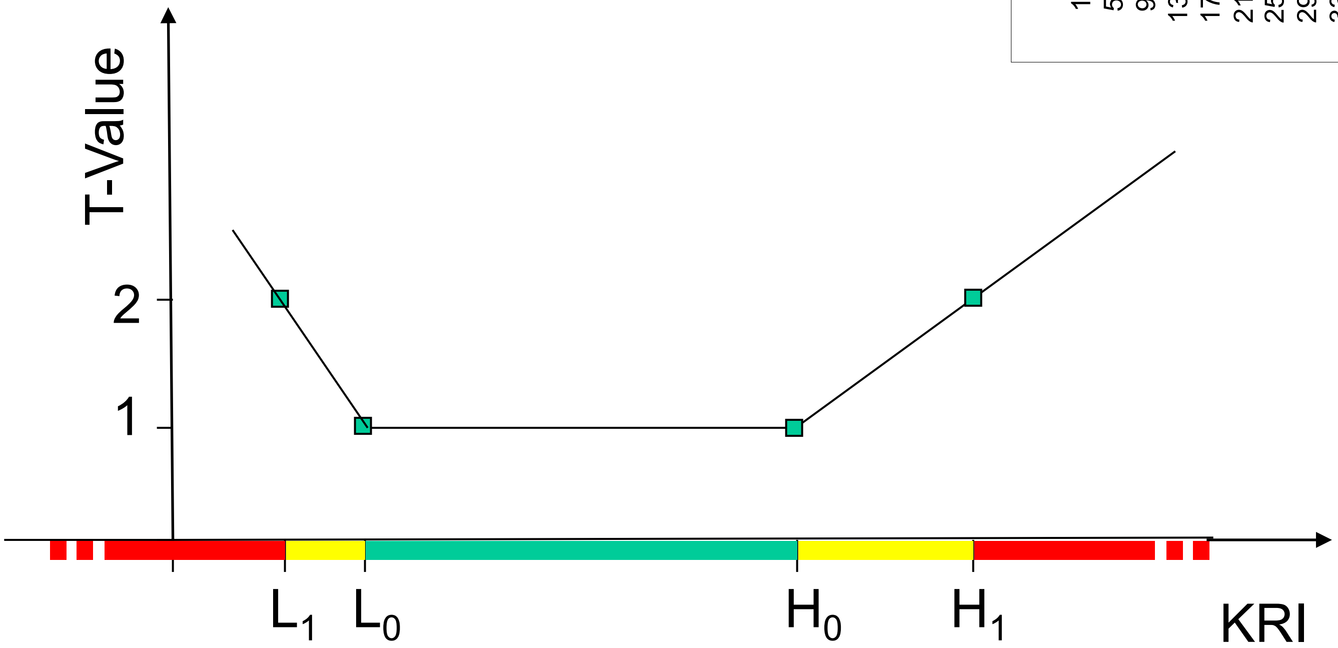
Tolerance transformation to T-Value





 Source: Charles Taylor, RMA

Basic principles

Related T-Values are combined by "multiplying" them:

NB: green x green = green, because 1 x 1 = 1.

yellow x yellow can equal yellow or red, because yellows on average between 1 and square root 2 multiply to less than 2, and yellows on average above square root 2 multiply to more than 2

Unrelated T-Values are combined by taking the "maximum":

NB: then the combined indicators tells us if anything really serious is happening in any of the covered areas

Source: Charles Taylor, RMA

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 Source: Charles Taylor, RMA

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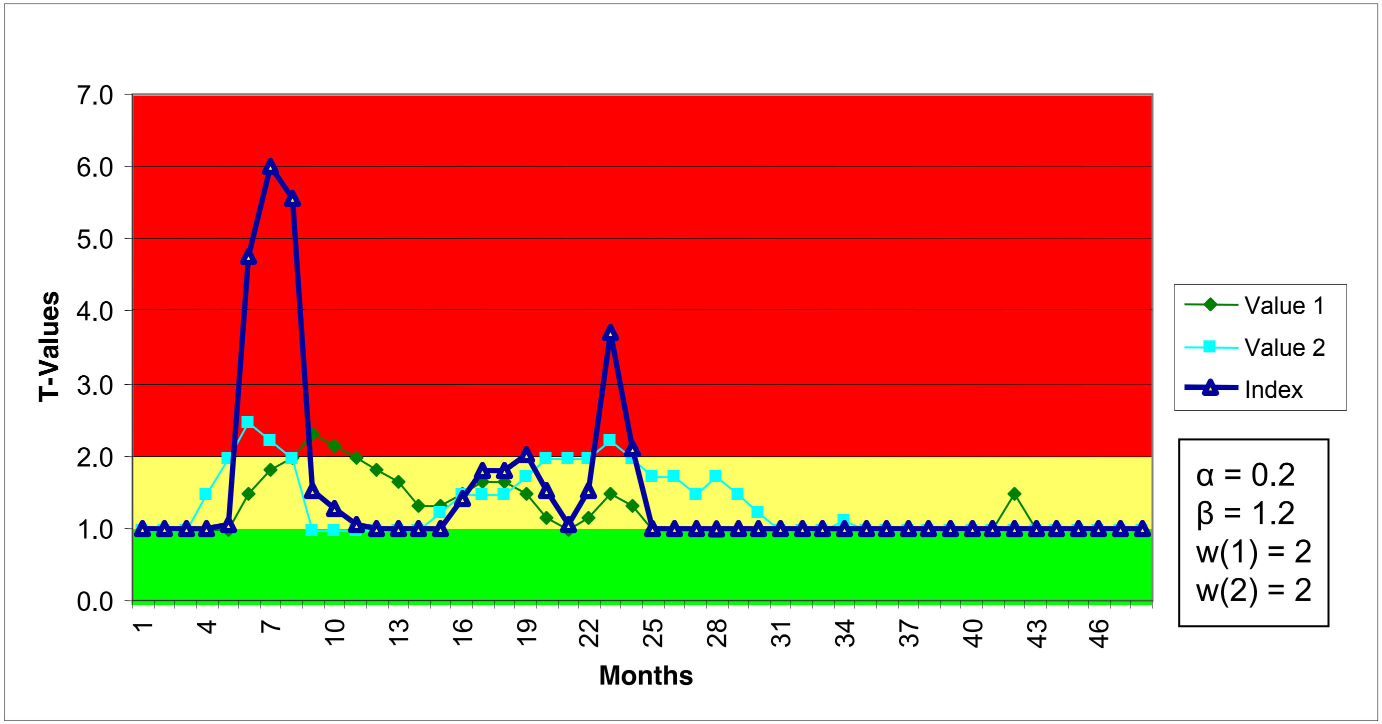
Composite index



Source: Charles Taylor, RMA, 2006

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Sources of information

- Internal information:
  - Risk assessment (ORSA) and scenario assessment data
  - Internal incidents or loss event data
  - Complaints, audit findings, control breaches and “near misses”
- External information:
  - Public sources, such as the press and internet
  - Commercial vendors of public information
  - Consortium data, derived from participants pooling their internal data together and sharing it

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Why join a consortium?

- It is not just about securing external data for use in calculating regulatory capital.
- There are numerous business benefits as well – consider the following actual case:
- Between 2006 - 2010, a mid-sized European firm lost €183 million to fraud, 83% of total losses:
  - External fraud : €110 million and 58.6% of total losses, average loss per event €9,000
  - Internal fraud : €73 million and 21.7% of total losses, average loss per event €165,000
- Management were concerned about the quantum but thought they were in line with their peers

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The benchmark eye-opener

- The firm decided to join a loss data consortium, pool their data and then compare themselves to the industry:
  - Industry fraud data reflected fraud averaged 20.8% of total losses over the same period – as compared to 83%
  - Industry ratio of internal fraud to external fraud was 17% to 83%, the firm's ratio was 36% to 64%
  - Industry total loss per €1 billion Gross Income was 1.67% and fraud comprised 21.03% of that
  - The firm's total loss per €1 billion Gross Income was 4.12% and fraud comprised 80.2% of that
- Management was correct to be concerned

Value of participation

- Internal event data is not necessarily always complete and can lose relevance over time
- Internal event data measures what has happened – external data highlights what could happen
- Consortium data is far more relevant and statistically more complete than data derived from public sources
- Data tends to be more homogeneous, mainly because of similar business mix, business environment and business volumes
- "*Community think*" – working with peers on sound practices, standards, classification issues, scaling, new concepts and approaches....
- Jump start for internal processes

ORIC International

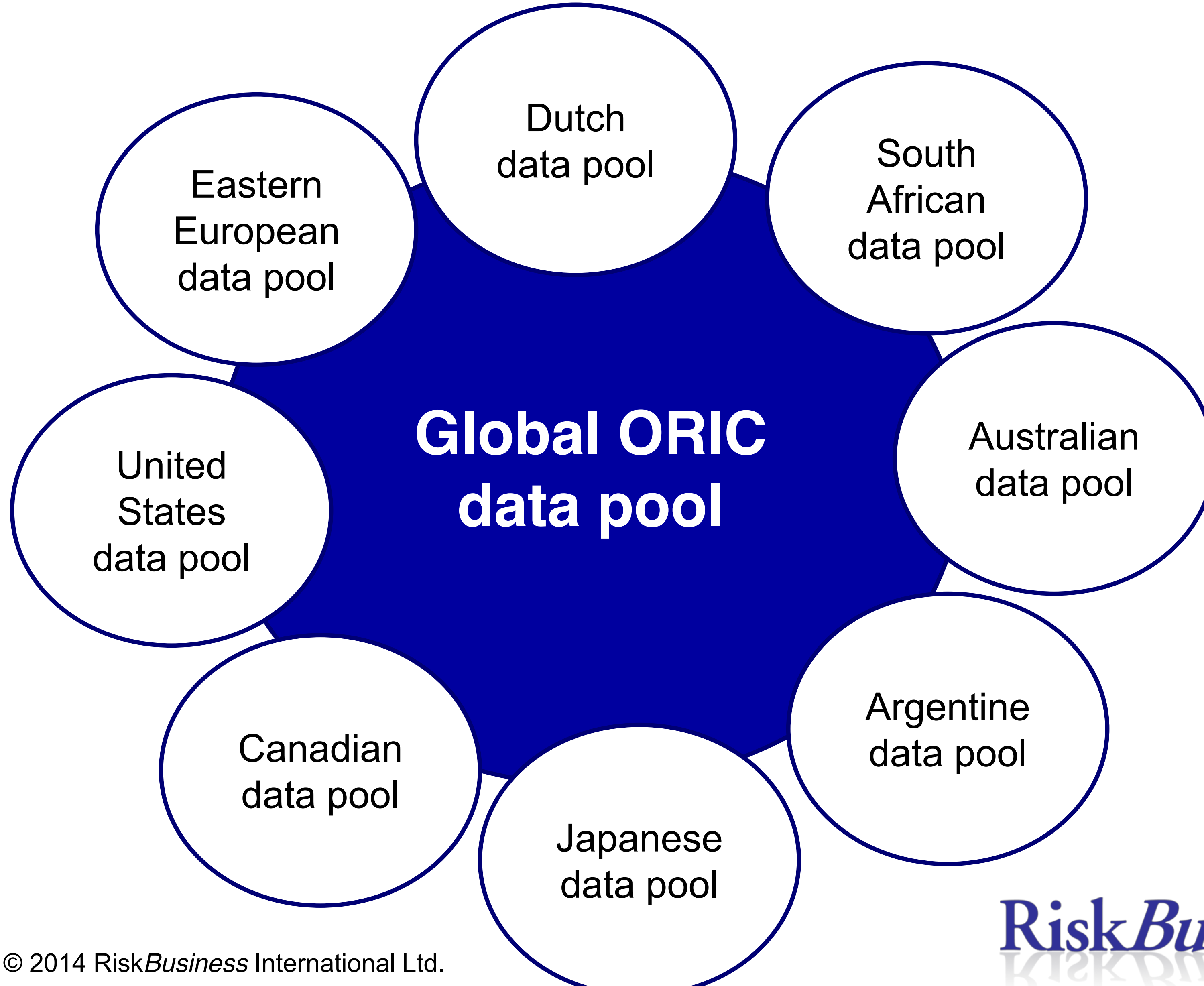
- ORIC has developed event collection, classification and reporting standards and taxonomies unique and specific to insurance
- Currently there are 13 active loss data consortia active globally
  - 10 of these are country-based banking consortia
  - 2 are global banking consortia
  - ORIC is the only consortium for insurance
- For further information or to join, please contact:

  Caroline Coombe, CEO of ORIC International

  caroline.coombe@abi.org.uk

  or hansruedi.schuetter@riskbusiness.com

Join together



ORIC activities

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In its 10th year of publication, the financial services industry's leading governance, Incisive Media's OpRisk & Compliance has issued 10 awards for initiatives and organizations for their significant contributions over the past decade to the discipline of operational risk management.
RiskBusiness received the award as one of two outstanding solution providers.

Our Software-as-a-Service solutions enjoy increasing popularity around the world, particularly in Emerging Markets. Contact us for details.

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