

FACTS AND MYTHS ABOUT BASEL

WHAT YOU NEED TO KNOW ABOUT BASEL III AND YOUR INSURANCE COVERAGES – NOW

1. IT WILL MATTER TO ALL U.S. BANKS

Let's be clear. The Basel Committee on Banking Supervision has absolutely no authority to impose the Basel III rules on U.S. financial institutions. Only U.S. supervisors – the OCC, the FDIC and the Fed – have the power to impose regulations on U.S. soil.

Unlike the initial 1988 Basel Accord and 1999's Basel II, U.S. supervisors appear determined to move forward with the stringent new capital rules. The other requirements may be adjusted and negotiations are still ongoing.

MYTH 1: *Basel III replaces Basel II and imposes a whole new set of rules and requirements.*

The new Basel III Rules are supplementary to the Basel II capital reforms finalized in July 2009.¹

2. THERE IS NO TIME TO WAIT

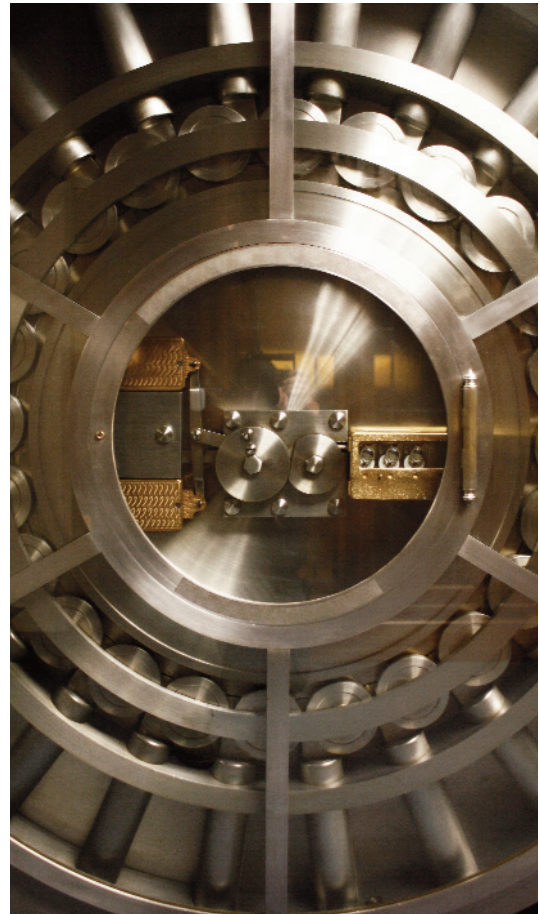
Regulators are already moving toward Basel compliance.

The OCC's Strategic Plan for fiscal years 2012-2016 released in September 2011 lists their strategic objectives, including their intent to cooperate with "international financial supervisory authorities on common interests...ensuring that Basel II and Basel III capital rule implementation embodies standards appropriate for the U.S. banking system."²

Another stated objective is to ensure prudential safety and soundness constraints. "The OCC seeks to fulfill this objective by: ... providing regulatory support for Basel II and Basel III capital rulemakings."³

MYTH 2: *Any increase in capital requirements is still years in the future.*

The new Basel capital rules are proposed to go into effect in 2013 and capital requirements would rise for all banks through 2015.



3. THE HIGHLY PUBLICIZED DEBATE OVER THE SURCHARGE FOR LARGE BANKS IS UNLIKELY TO IMPACT MOST BANKS

Leading bankers have been complaining in the press about the inequality of the rule that will require additional capital from large multinational banks or G-SIFIs (global systemically important financial institutions). Their complaint is that the largest banks, many of them American, will be unfairly disadvantaged.⁴

This surcharge, called the capital conservation buffer, will only impact the institutions deemed G-SIFI. The controversy

may actually be drawing attention away from the fact that the new capital requirements are fast approaching.

MYTH 3: Insurance only impacts the capital of the largest banks.

Any bank taking advantage of the advanced accounting methods available can potentially reduce their operating risk capital requirement. The savings that can be achieved through application of insurance are real and should not be ignored.

4. YOUR CURRENT INSURANCE POLICIES MAY NOT HELP YOU REDUCE YOUR OPERATING CAPITAL REQUIREMENT.

Only financial institutions that adopt the Advanced Measurement Approach (AMA) of risk measurement⁵ can employ insurance to mitigate operational risk capital.⁶ Even banks choosing AMA must be careful to ensure that the actual policies are compliant. That doesn't mean that other institutions shouldn't take advantage of risk mitigation techniques to improve their capital position.

The goal of these measurement approaches and weighing the value of insurance coverages is capital efficiency. The Basel Committee on Banking Supervision outlined the "risk-mitigating impact" of insurance on an institution's capital in an important 2010 publication⁷ and provided a road map for how to improve capital efficiency utilizing insurance programs. Even

banks using the Standardized Approach (as opposed to AMA) are able to reduce their excess 'operational risk' with proper use of insurance.

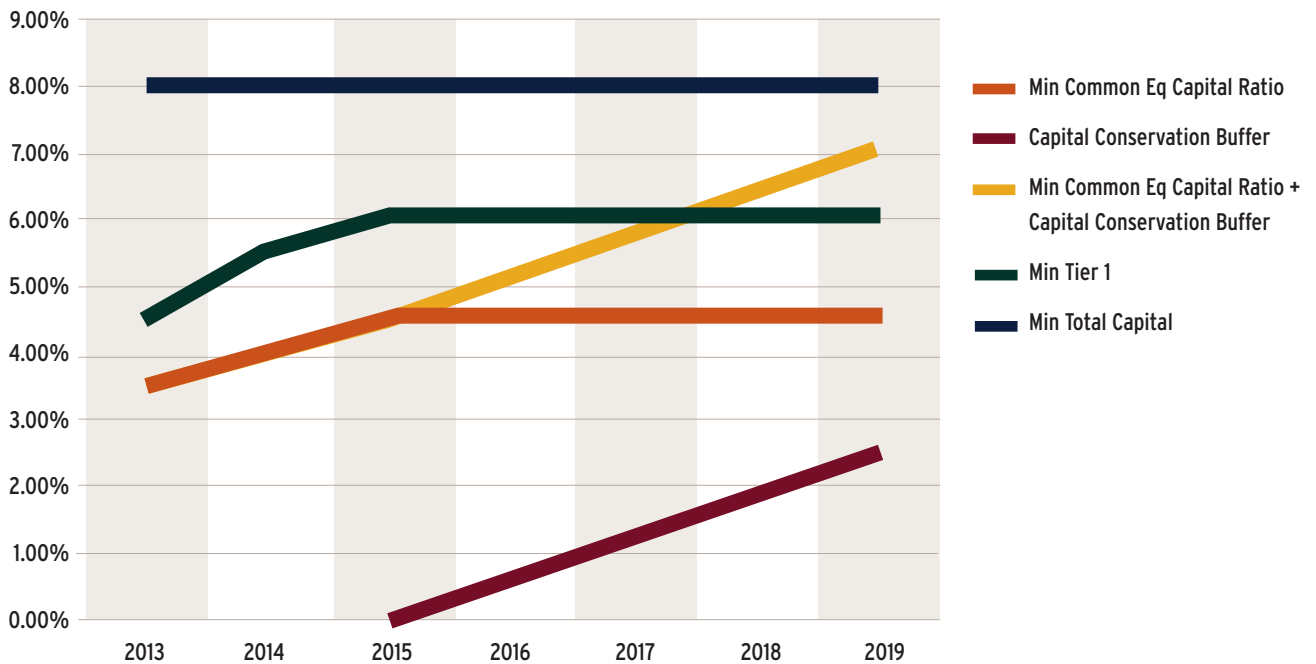
To be suitable for consideration for capital reduction, policies must have:

- A minimum term of 12 months at any moment
- A cancellation period of not less than 90 days
- No exclusions triggered by regulatory or receiver's actions
- A carrier with a rating of "A" or better
- Clear cancellation and non-renewal periods

Willis has recently carried out work with non-bank financial institutions to include insurance in their economic capital.

MYTH 4: Any broker can help me with these new requirements.

Most brokers don't have the years of experience that Willis has gained in dealing with Basel-compliant policies, both in Europe and with larger U.S. institutions.



EXAMPLE OF INSURANCE REDUCING REQUIRED REGULATORY CAPITAL

A bank with \$20 billion in assets is told to reserve 8% capital and currently pays \$5 million for its insurance policies.

BANK ASSETS \$20 billion

REQUIRED CAPITAL @ 8% \$1.6 billion

After calculating the Required Capital to Offset Operating Risk using the *Standardized Approach*, it is determined that the bank needs to reserve:

\$192 million

OPERATING RISK CAPITAL REQUIREMENT By using the *Advanced Measurement Approach* the bank reduces the operating risk capital requirement to:

\$150 million

CAPITAL COVERED BY INSURANCE Modeling, using the Willis Capital Methodology, determines that insurance coverage would represent 12% of the capital requirements:

\$18 million (12% of \$150 million)

NET CAPITAL TO BE RESERVED FOR OPERATING RISKS Subtracting the need for the insured portion of their regulatory capital, the bank is left reserving capital against operational risk of:

\$132 million (\$150 million - \$18 million)

CAPITAL COVERED BY INSURANCE & COST OF CAPITAL SAVINGS The \$18 million of capital that is no longer required also saves on the cost of that capital. Assuming saved opportunity cost of 15%, the bank would save an additional \$2.7 million or:

\$20.7 million (\$18 million + \$2.7 million)

NET SAVINGS RESULTING FROM THE PURCHASE OF INSURANCE If the bank is spending \$5 million annually to purchase its insurance policies, the resulting savings resulting from the reduction in necessary capital is:

\$15.7 million (\$20.7 million less \$5 million premium)

ASSESSING YOUR CAPITAL NEEDS THROUGH THE INTERNAL CAPITAL ADEQUACY ASSESSMENT PROCESS

Your regulators will only allow your institution to reduce your capital by insuring risks if you have met certain basic requirements. You must be using the Advanced Measurement Approach, and part of that approach includes properly assessing your risk and requisite capital. In fact the OCC requires that “a bank must have a rigorous process for assessing its overall capital adequacy in relation to its risk profile and a comprehensive strategy for maintaining an appropriate level of capital.”⁸ A bank must conduct this assessment, using a process called Internal Capital Adequacy Assessment Process (ICAAP).

FOUR CRUCIAL ELEMENTS IN ANY ICAAP ARE:

1. Assessment (identification and measurement) of bank’s risks
2. Application of mitigation techniques
3. Stress-testing techniques
4. Role of the board of directors and management

A bank must show that ICAAP is an integral part of its processes and demonstrate that senior management both supports and is engaged in the ICAAP. In addition, institutions need to explain in detail to their supervisors how they will use the ICAAP as they move forward and how key risk indicators and economic capital assumptions can be updated and presented to the board of directors when required. Banks are being encouraged to embrace the process for the sake of their business rather than for purposes of regulatory compliance alone. Management should understand the positive benefits and strive, through ICAAP, to make their business more efficient and less risky.

WILLIS CAPITAL METHODOLOGY

Willis can assist you with your bank's Internal Capital Adequacy Assessment Process.

Our firm has developed the Willis Capital Methodology. This technique has the twin aims of maximizing the insurance benefit from a capital perspective, as well as using the analysis to optimize your insurance program at renewal. For your bank to obtain the maximum capital benefit for your insurance coverages it is critical that your underlying policies meet the criteria dictated by the Basel Accords. Willis can help tailor your policies to qualify for this vital benefit.

IDENTIFICATION OF RISKS

To begin, your current insurance program is mapped by two independent groups of Willis insurance experts and aligned to each of your institution's main risk types to determine certainty of insurance response.

In order to clarify certainty of response (and thereby Basel compliance), risk events necessarily need to detail specific causes and risk consequences and be quantified as a proportion of the overall severity for a given risk.

Each individual cause-event-consequence combination is mapped to the insurance program. Potential insurance recoveries for each consequence of each event/scenario are calculated to determine the probability to trigger the insurance contract.

SUMMARY OUTPUT

Once Willis has completed its analysis your bank will be provided with the data necessary to complete its ICAAP and seek adjustment to its risk operating capital requirements. That output will include:

1. The total aggregate undiversified capital is \$_____.
2. The net capital taking into account a XX% diversification benefit is \$_____.
3. The total aggregate undiversified insurance benefit is \$_____ or XX% of the total undiversified capital.
4. The net insurance benefit taking into account a XX% diversification benefit is \$_____ or XX% of the net capital.

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The observations, comments and suggestions we have made in this publication are advisory and are not intended nor should they be taken as legal or financial advice. Please contact your own legal or financial adviser for an analysis of your specific facts and circumstances.

¹ The Basel II capital requirements were contained in the 2009 "Enhancements to the Basel II framework," <http://www.bis.org/publ/bcbs157.pdf>

² <http://www.occ.gov/publications/publications-by-type/other-publications-reports/stratplan.pdf>

³ Ibid

⁴ <http://dealbook.nytimes.com/2011/09/12/dimon-calls-capital-rules-anti-american/>

⁵ As opposed to the more common Basic Indicator or Standardized Approach

⁶ <http://www.bis.org/publ/bcbs196.htm>

⁷ <http://www.bis.org/publ/bcbs181.pdf>

⁸ <http://www.occ.gov/news-issuances/federal-register/73fr44620.pdf>