

FINANCIAL INSTITUTIONS MARKET REVIEW

It will take some time before property and casualty insurers are able to fully evaluate their exposure to the devastating events in Japan, but from the outset, some market commentators began to predict that the loss would be large enough to become market changing. Joe Plumeri, chief executive of Willis Group said during a presentation to investors “Very early when Japan occurred everybody thought that the rates were going to spike up and it would be a great excuse for the insurance companies to raise rates,” he went on to comment “That’s abated by now.” At present the prevailing opinion suggests that it will be treated as earnings as opposed to a capital event, with only a localised effect on pricing. What will be of concern to Underwriters is that, given the severity of quarter one, the rest of 2011 will be a very nervous wait; if the Japanese earthquake and tsunami are not enough to turn the market, then surely large additional losses from the Atlantic hurricane season will be.

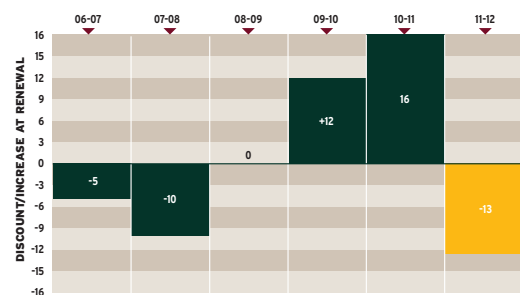
So what effect will this have on the financial institutions market place? There is no direct correlation between the losses that will be sustained in Japan and financial institution insurance, so to date we have not seen any direct ramifications. However, if indeed the international market for property and casualty does seriously deteriorate we would expect to feel some effects. If other sectors of the market place see significant improvement in rates, capital could be reallocated to these classes of business at the expense of the financial institutions market. There is precedent for this reallocation. Losses following the World Trade Centre disaster barely correlated with financial institution insurance. However, business capital left the financial institutions insurance market place, reallocated to the short tail, high priced property and casualty insurance. This helped contribute to several years of tough financial lines market conditions.

Some financial institution underwriters appear increasingly frustrated at a market continuing to reduce pricing and looking for a credible excuse to impose more conservative underwriting.

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Even if we do eventually see the financial institutions insurance market toughening up, we do not expect such changes to manifest themselves in the short term. In the current environment (and given there are no further serious events) we would expect the market to continue in its current state at least until the end of the year when insurers renew their annual treaties. This negotiation with reinsurers will be the next definite indicator of the state of the market.

ACTUAL AND PREDICTED MARKET CYCLE



SYSTEMIC RISK: THE INSURANCE IMPLICATIONS

Even before the economic crisis regulators were making it clear that they intended to increase their focus on the quality of systems and controls within financial institutions, and to hold senior management liable for failures. We can only expect to see an increase in their resolve. An overarching focus, of course, is the need to prevent systemic risk – an underlying failure of control running through an organisation, rather than a one off incident. We look below at the tensions between how this might operate from an insurance, as opposed to a regulatory or management, perspective.

Systemic risk is of great interest to insurance underwriters of professional indemnity insurance policies, and this concern can evidence itself in a number of ways. Perhaps the most obvious is when underwriters are considering the placement of the risk. They seek, on the basis of the information provided to them, to evaluate their own risk of a claim being made on the policy. A series of queries therefore focus on legal and compliance controls, risk departments and committees, and new business and new product sign off processes. Detailed points can also arise at the point of claims notification and handling. This is particularly pertinent at the moment given the increase in misselling and misrepresentation claims alleged against financial institutions, which may well fall within the scope of professional indemnity insurance cover. From a regulator's perspective, it may be less concerning if a particular set of complaints or concerns are capable of being categorised as isolated incidents, rather than all arising from an underlying systemic problem. But what is the effect of this analysis on the extent of professional indemnity insurance cover available?

Professional indemnity insurance will generally operate on the basis that a deductible will apply to each claim, with an aggregate limit on the value of each claim and/or on the value of all claims in the policy year. The net result is that, if an insured is facing a number of small claims, it may be desirable to show that those claims are all connected, and can be aggregated together, to maximise the claim under the insurance. In general terms, whether claims can be aggregated depends upon identifying a common theme or cause(s) which links the claims or from which they originate. However, there are quite wide variations in the wordings used in insurance policies of this type for financial institutions, and their effects.

The House of Lords looked at this area in the context of pensions misselling (**Lloyds TSB General Insurance Holdings v Lloyds Bank Group Ins Co.** [2003] UKHL 48). The GBP1 million deductible in this case meant that small claims would not be recovered from insurers unless they could be aggregated. The bank asserted that it had a systemic failure, in that it failed to institute a proper training scheme and that factor effectively connected all the misselling by all of its agents or representatives. It was held, however, that the underlying failure of management to institute training systems was not the cause of the loss. Additionally on the construction of the relevant aggregation clause, there was no related series of acts or omissions. This meant that Lloyds TSB suffered irrecoverable losses from an insurance point of view.

There are wider insurance policy wordings available which may have led to a different result in the Lloyds TSB case. Whether a wide or narrow wording is the most appropriate depends on the risk profile of the particular financial institution, the level of the deductible and the application of any aggregate limits. If the aggregation wording is narrow it will be harder for an insured to aggregate small claims in order to erode the deductible, but correspondingly it will be harder for insurers to pool a number of larger claims in order to exhaust any aggregate limit on a series of claims. If the wording is wider, it is more likely that small claims can be aggregated together to exceed the deductible. In our experience it is important that insureds consider carefully with the insurance broker placing the risk what is likely to be the most appropriate wording, as without careful consideration the institution runs the risk of uninsured losses or claims.

Claire Nightingale

Professional Risks – FI
FINEX Global

ASSET MANAGEMENT

RISK AND ANALYTICS SERVICES - FINEX GLOBAL, WILLIS GROUP

The Risk and Analytics Practice within FINEX Global has brought together a wealth of experience and analytical talent across the Willis Group to help asset management firms navigate current challenges in the areas of operational risk exposure management, risk mitigation spend and capital efficiency.

We can provide in depth research and analytical tools to help firms make well-reasoned decisions on the effective use of risk financing and transfer – with a view to reducing the total cost of risk to the organisation. We also assist firms in the effective use of insurance from an earnings at risk/economic capital perspective.

Operational Risk and Insurance: Observed Trends and Current Challenges

AREAS OF FOCUS	KEY CHALLENGES	LEADING PRACTISES OBSERVED
A) Aligning risk financing/transfer to the firm's operational risk profile	<ul style="list-style-type: none">– Determining the profile of insurable (operational) risk exposures	<ul style="list-style-type: none">– Gap analysis of insured vs. insurable risks compared to the firm's operational risk exposure profile– Medium-term risk financing/transfer strategy cognisant of the firm's risk profile, risk appetite and the availability, cost and effectiveness of risk transfer instruments– Insurance mitigation is an integral part of the firm's operational risk management process
B) Risk transfer (insurance) valuation/capital contribution	<ul style="list-style-type: none">– Operational risk/ insurance mapping to AMA Pillar 1 standard– Accounting for timeliness and certainty of payment, as well as event coverage within the capital model	<ul style="list-style-type: none">– Mapping of entire insurance programme to capital intensive operational risk events– Developing sound methodologies and calculations for the capital valuation of risk transfer within the firm's ICAAP

Strategic Benefits

Our risk services and solutions bring value to asset management firms in the following ways:

- Informed decision making on the extent, structure and value of insurance, in light of the firm's operational risk exposure profile
- Minimise the surprise of unexpected losses that can lead to potentially uninsured claims by aligning insurance coverage to actual operational risk exposures (cause-event-consequence)
- Strategically utilise risk transfer and insurance in risk-based capital terms (economic/regulatory capital)
- Generate an audit trail of decision making about risk mitigation and insurance as part of a programme of good governance and asset protection

WILLIS' FINEX GLOBAL DIVISION APPOINTS DR. PAUL SEARCH AS HEAD OF RISK AND ANALYTICS



Dr. Paul Search has been appointed Executive Director and Head of Risk and Analytics for FINEX Global, Willis' financial, executive risk and professional liability business, effective immediately. Based in London and reporting to Duncan Holmes, Managing Director, FINEX Global, Search will lead the newly created Risk and Analytics Practice within the division.

Dr. Search will spearhead thought leadership in risk analytics and consulting services for international financial institutions, professional service firms and major corporate clients. By harnessing industry knowledge and expertise from across the Willis Group, and applying risk and insurance insights and analysis, Search will deliver risk management and insurance solutions to FINEX Global's clients.

Dr. Search joins Willis after 12 years at Marsh where he held the position of Head of Operational Risk and Senior Vice President of the Financial Services Practice. In this role he was responsible for areas of client engagement including operational risk/Basel II consulting and capital mitigation, regulatory risk advice and strategic insurance reviews.

Commenting on the appointment, FINEX Global Chairman Roland Avery said, "We are delighted that Paul has joined Willis to lead our new Risk & Analytics Practice within FINEX Global. Paul and the team will work closely with Willis' leading analytics and risk advisory teams to further enhance FINEX Global's development of risk and insurance solutions for clients in the financial, professional and corporate sectors".

Dr. Search holds a PhD in Economics from the University of London and is a Fellow of Institute of Risk Management.

MEET THE TEAM



EMILY HOLLOWAY

Emily Holloway recently joined the FINEX National London team as a Business Development Executive/Account Executive.

Emily has spent over seven years in the insurance industry, and the last five years specialising in financial institutions and focusing on insurance solutions for the alternative asset sector. Prior to joining Willis, Emily worked at Windsor Partners, where she was responsible for targeting and converting new business across all financial institutions, with particular experience in the private equity and investment sector and, geographically, the U.K. and Channel Islands. Emily also worked at Howden where she was Head of Offshore Funds and was instrumental in developing and growing their client base.

Emily enjoys many activities including running and completed the London Marathon in 2010 in a very respectable time of just over four hours.



NICK BACHMANN

Nick Bachmann recently joined the FINEX National London team as a Business Development Executive/Account Executive. Nick will

be developing relationships and new business opportunities throughout the Channel Islands promoting PI and D&O Insurance to Fund Administrators and Service Providers.

Prior to joining Willis, Nick has had a number of project management roles, primarily in implementing online communication solutions for blue chips.

Nick lives in Guernsey with his wife and young daughter and is currently looking forward to the birth of his second child. In his spare time Nick enjoys playing football, hockey and surfing.

To discuss your insurance arrangements with the Willis FI team please call your Account Executive or Paul Richards on +44 (0)20 7558 9240 or e-mail prichards@willis.com.

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