

# The Willis Index

# Willis

## Financial Institutions Newsletter

The Financial Institutions Insurance and Risk Management Quarterly

Q2 2005

## Market Conditions and Results of the Market Survey

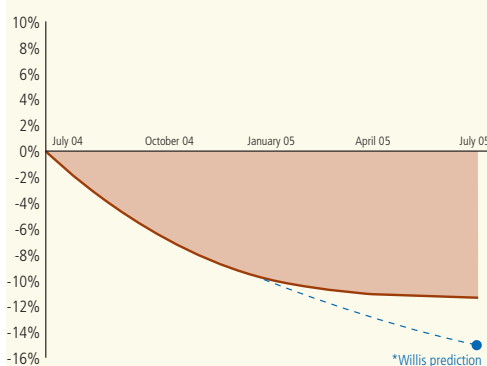
Market conditions for the first quarter of 2005 have become increasingly favourable and the Willis Index shows that respondents are now beginning to acknowledge that premium rates are decreasing for many financial institutions by between one and ten percent. This is in contrast to the last Willis Index where most respondents were anticipating renewals to be as expiry or even a small increase in premium. We would counter that where a financial institution has not experienced a premium reduction in recent years it is often possible to negotiate discounts of greater than 20% although this is of course dependent on the specifics of the assured and the success of the marketing strategy.

Underwriters are suggesting that the overall trend for limits and deductibles appears to be flat and, on the whole, Willis would agree with this. However, we increasingly see some financial institutions using premium saved across a program to purchase higher limits or perhaps a new product such as Employment Practices Liability and we anticipate that this trend will increase through 2005. We would also expect policyholders to consider using their increased buying power to reduce deductibles to a level which provides a higher degree of comfort.

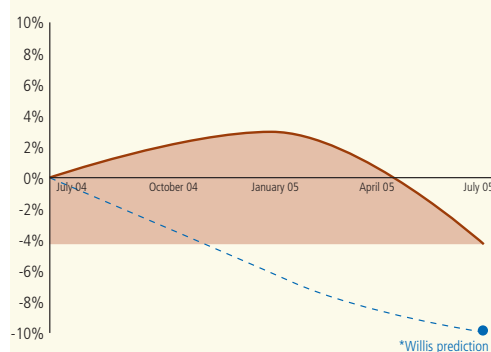
Most underwriters are not admitting to a broadening of coverage terms however this is in contrast to almost all business that Willis has seen this year. We continue to see coverage terms improving across all classes of business; in particular Professional Indemnity and Directors' and Officers' insurance, albeit in most cases considerable negotiation is required to obtain the best product.

A key indicator of the state of the market in 2005 was the reinsurance renewal season which for the majority of underwriters occurred at the beginning of the calendar year. We understand that on the most part underwriters obtained treaty renewal terms that were at the same rate as last year, although in some cases reinsurers were able to impose some wording

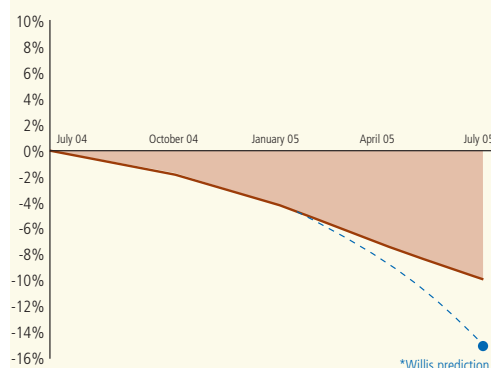
### Directors' and Officers' Premium Change



### Professional Indemnity Premium Change



### Comprehensive Crime Premium Change



\*The Willis prediction is based on multiple criteria and does not relate to the situation for each organisation.

The Willis Index is a quarterly publication reporting on the relevant issues affecting the insurance industry and the impact they have upon the Financial Institutions sector. The main feature is an extensive market survey taken from over 50 insurers, providing responses on key indicators including premium, excesses and cover.

Our quarterly analysis provides buyers with an overview of insurance market conditions and our assessment of the outlook.

In this issue we investigate the increase in employment practice claims made by employees and consider the role of cyber policies, to protect against the internet risks not covered by more traditional insurance policies.

We also provide a Basel II update, and provide details of our next seminar and latest policy wording release.

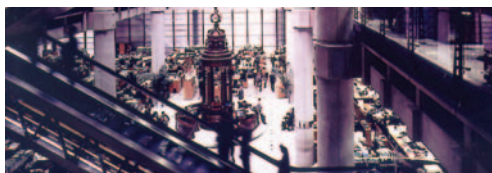
### Contents

Market Conditions and Results of the Market Survey	1
Beware the Disgruntled Employee	2
Willis Develops New Hedge fund D&O Wording	2
Basel II Update	3
Virtual Fraud	
– The Dangers Posed by Hacking	3
Meet the Team	4
Seminar Details	4

## Market Conditions and Results of the Market Survey (continued)

restrictions. This suggests that the slight market softening that we see at the moment has been heavily influenced by the influx of new competition as opposed to underwriters being able to reduce their own expenses. However this only reinforces the need for a strong marketing strategy generating and capitalising on market competition where appropriate to obtain the optimum renewal terms.

Looking forward is a slightly more difficult proposition as we continue to await the resolution of the large settlements (Enron, Worldcom, Parmalat, Laddering etc.) that are likely to have a material effect on many Underwriters results. Some commentators are suggesting that large settlements by the insurance market in these cases will catalyse the hardening market cycle effectively ensuring that the slight softening that we are currently experiencing is short lived. We feel it is important to point out however that there is still a degree of uncertainty when this could take place and indeed how far reaching the effects will be to financial institutions that do not have exposure to these sort of events.



### Willis Develops New Hedge Fund D&O Wording

Say goodbye to the inappropriate policy wordings and exclusions that remove all semblance of cover for the directors and officers of Hedge Funds. Willis has launched a new Directors' & Officers' Liability wording that has removed the onerous exclusions to which many Hedge Funds have been exposed.

Underwriters have become more comfortable with the Hedge Fund Directors' & Officers' Liability risk. The good historic loss record combined with the increased competition in this sector has allowed us to improve the policy wordings and negotiate premium reductions. It is the right time to review cover as there is increasing regulatory scrutiny of Hedge Funds.

Willis has increased its Hedge Fund resources and sets out to demystify the protection offered by Directors' & Officers' Liability and Professional Indemnity Insurance.

## Beware the Disgruntled Employee

The problems associated with Employment Practices Liability (EPL) are now a global issue for financial institutions. Whilst the EPL product was originally developed in the USA, former employees now use their right of redress against former employers in many jurisdictions.

In the UK, over the last three years there have been a number of high profile EPL cases involving financial institutions. According to reports the amounts involved are increasing.

In mid 2002 Jane Bower won a payment of £1.4 million in her sex discrimination case against Schroder Securities and in April 2003, Louise Barton won her appeal against Investec in her sex discrimination case.

During 2003, the most notable cases involved Phillip Karam (racial discrimination) who was awarded £200,000 against Credit Suisse First Boston and Steve Horkulak (bullying) awarded £912,000 against Cantor Fitzgerald.

EPL warrants careful consideration as awards increase.

The cases continued in 2004, as Merrill Lynch faced two high profiles cases. In July, they agreed a settlement of £1 million with Elizabeth Weston, an in-house lawyer, over inappropriate comments made at a Christmas party.

It would appear that financial institutions are currently the leading industry sector for such cases in this country. We do not believe this will change. We would not say that the amounts involved will reach the levels witnessed in the USA, but they are growing and financial institutions must examine their risk exposure.

It appears that financial institutions in the UK are facing allegations from a more sophisticated claimant, who realises that there is a cap of £55,000 that can be awarded by an Employment Tribunal for wrongful dismissal and therefore tends to pursue claims alleging discrimination for which awards are not capped.

New employment laws banning discrimination against employees on grounds of religion and sexual orientation have recently been brought into force and in 2005/6 employers face additional legislation including the Disability Discrimination Act and the Employment Framework Directive, concerning the issue of ageism. This is a subject that will continue to be discussed.

The latest figures from the Employment Tribunals Service advise that for the year ending March 2004 the total number of applications received increased to 115,042 compared to 98,617 for the previous year. In addition, cases are becoming more complex especially in the area of discrimination. Some UK financial institutions were able to extend their Directors' & Officers' Liability policies to provide EPL coverage in the late 1990s. Some, however, suffered losses and this together with the 'back to basics' attitude to underwriting by insurers over recent years, caused EPL coverage to be deleted from many Directors' & Officers' Liability policies.

Generally EPL cover is now provided as a stand alone policy, and the number of insurers prepared to offer such policies for financial institutions is well defined. Policies typically extend to cover a wide range of possible employment practice violations including unfair dismissal, wrongful failure to employ or promote, racial, sexual or disability harassment, and discrimination based on age, gender, race, religion, sexual preference or pregnancy.

Insurers do not aim to replace the human resources departments of clients and therefore aim to offer coverage on a catastrophe basis. Most insurers would expect a major financial institution to take a deductible of at least £100,000 each and every claim.

Not every financial institution will decide to purchase EPL insurance, however, but every financial institution should recognise the potential issue, the growing amounts involved and the possible mitigation offered by the insurance marketplace.

# Basel II Update

# Virtual Fraud – The Dangers Posed by Hacking

## The FSA Consult on the Implementation of Basel II

The FSA are currently in consultation with the finance industry regarding the implementation of Basel II via the Capital Requirements Directive (CRD) of the EU.

Consultative Paper CP05/3 'Strengthening Capital Standards' is one of two consultative papers the FSA will publish this year in connection with the implementation of Basel II. It concentrates on the areas where the UK is expected to have discretion in deciding how to apply the CRD. It supersedes CP189 of July 2003. It applies to all deposit-takers (other than credit unions) and to investment firms. It also applies to certain groups containing such firms, where headed by one of these firms or by a financial holding company.

## Operational Risk

Among other things, CP05/3 outlines the purpose of the Operational Risk requirements and the Operational Risk measurement methodologies available to calculate these. It also describes the proposed exemption from the Operational Risk capital requirements available to investment firms that do not deal for their own account.

The FSA have also published preliminary details of a Cost Benefit Analysis of the CRD (contained within Annex 2 of CP05/3). It was published following a project commissioned by the FSA to investigate the economic impact of the various implementation options of CRD. Both credit and non-credit firms have expressed concern over the costs against the benefit of Operational Risk provisions.

A full Cost Benefit Analysis of the UK implementation of the CRD will be conducted when the full set of draft rules and guidance are published.

## QIS 5 and USA Basel Delays

The US federal banking supervision are delaying issuing the detailed plans required for Basel II implementation. This brings into questions the ability of the USA to keep to the proposed implementation deadline of January 2008.

The Fourth quantitative impact study (QIS 4) showed evidence, in the USA, of reductions in the amount of capital banks would be required to hold against risk, compared to existing rules.

Computer and electronic crime policies for financial institutions have been provided by the insurance market for four decades and it is arguably the case that the standard forms used by insurers have failed to keep step with the internet, e-commerce and the sophisticated computer usage which now characterises all institutions, financial or otherwise. The problem is often perceived to be in the increasing exposure to a more sophisticated battery of hackers with a seemingly ever accelerating ability to breed new viruses, worms and trojans.

There are undeniably gaps in conventional policies. In many, the question of whether or not access via internet or e-mail is covered is unclear – certainly, any cover for websites and the attacks on them or the liabilities which arise from them, are not covered by conventional policies, if only because they do not reside "in the Assured's computer".

It is certain that cover is not provided for exposures such as:

- business interruption and extra expense following computer breakdown
- website content liability
- intellectual property rights violation
- computer attacks (SPAM, virus or other) leading to access denial/service disruption
- the intrinsic value of the Assured's trade secrets/intellectual property.

The insurance market has been providing 'cyber policies' to fill these gaps for more than

five years but they have not been available to financial institutions. Reluctance to extend these policies to the finance industry stems from its vulnerability to significant losses in these areas.

However, insurer interest in extending cyber coverage to financial institutions is now noticeably increasing and new products have appeared recently. Our market knowledge shows that there is approximately £50 million of available limit for cyber cover on any one risk. Our analysis of such products highlight that the cost of such products and the need to dovetail them into existing computer crime and civil liability policies makes extending the cover provided under established policies a better solution.

This view is reinforced in part by the fact that the new products seem to duplicate a significant amount of cover already provided by conventional computer crime and civil liability policies, whilst adding a number of what might be regarded as frills such as criminal reward funds and crisis management costs to manage risks to the Assured's computer security reputation – to the degree that there seems little proportionate benefit yet more premium cost.

We are highly experienced in analysing cyber coverage issues and delivering modifications to insurers standard products where needed in order to provide leading edge coverage for our clients.

Global banking regulators' plan to re-test the potential effects of the complex Basel II bank safety rules on banks around the world between October and December (QIS 5 the fifth Basel II quantitative impact study) has been brought forward by three months to the October – December period at US urging.



## Meet the Associates

### John Naish

A banker by background and training, John Naish began his City career with merchant bankers Hill Samuel in 1969.

From the early 1970's, Asia, primarily Japan, became the prime focus of his activities and as well as travelling regularly within the Asian region he lived for some years in both Hong Kong and Tokyo. Joining NatWest Markets in London in 1994, he relocated to Tokyo for a second time, returning to the UK in 1996.

"The 1970's and 1980's were exciting times in Japan", he comments, "and even with the slowdown since the 1990's, Tokyo is still an invigorating place to visit."

John's other main concern was maintaining relationships with banks in Europe and elsewhere, helping Hill Samuel to grow its extensive money market and derivative dealing activities. He recalls the rapidity of product development and innovation as the revolution in computing power became allied with the original thinking of the financial sector's "rocket scientists".

John joined Willis in 1997 to help build the company's Japanese financial institutional



practice. In addition to this, his banking background led to him becoming one of the originators of Willis' involvement in the international banking debate on regulatory capital for operational risk.

A significant part of this was the development of the Willis Operational Risk Loss Database – "WORLD". John notes, "It had become clear that our clients needed information on operational risk loss events. We had always maintained a simple database of events highlighting the application of the various insurances. Broadening its coverage and making it password accessible via our web site has made it a useful source of ideas for operational risk scenario analysis."

A keen ("but like most of us not good") golfer, John has also had a life long interest in Astronomy. One of his boyhood memories is of meeting and chatting with Patrick Moore after one of his lectures.

Married with two sons, John commutes into the City from Twickenham. A reasonably convenient journey despite the vagaries of London's transportation system, John wishes London's light pollution would not reach out so far and spoil the night sky and his star gazing.

## Seminar Details

Our next Professional Risks Seminar is scheduled for Thursday 23rd June in our Head Office, Ten Trinity Square, London.

'Financial Risks Claims - What Happens When Disaster Strikes?' will cover topics such as claims payment, contract certainty, and insurers. It will also include a review of the latest results of the Willis Index survey.



10 Trinity Square

### Breaking News

Willis has been named the "2005 European Commercial Broker of the Year" as voted on by more than 3,000 risk and/or insurance managers or directors of multinational companies across 12 European countries (Belgium, Denmark, France, Germany, Italy, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland and the United Kingdom).

Willis is one of the World's leading risk management and insurance intermediaries. We have 15,800 professionals in over 300 offices around the World.

For further information please contact:

#### Derek Reeves

Tel: +44 (0)20 7975 2944  
Email: reevesd@willis.com

#### Reg Holden

Tel: +44 (0)20 7975 2012  
Email: holdenr@willis.com

#### John Naish

Tel: +44 (0)20 7975 2054  
Email: naishj@willis.com

Willis Limited, Registered number: 181116 England and Wales.  
Registered address: Ten Trinity Square, London EC3P 3AX.  
Lloyd's Broker. Authorised and regulated by the Financial Services Authority.