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THE TGP NEWSLETTER: ISSUE No 7 NOVEMBER 2007

Operational Risk – where things really go wrong

Are there parallels for Northern Rock in the insurance business?
Have we been here before and can it happen again?

In our September paper on Solvency II we ended up by asking if the new regime constituted a good thing for customers? On the face of it, we said, lower capital should mean lower premiums – a good thing. But we also asked whether such a move would increase the failure risk if compensating improvements were not made in managing operational, or enterprise, risk. That bulletin was actually written, but not distributed, before certain events occurred in the banking arena, and we might, therefore, make some modest claim to prescience. Basle II is the banking equivalent of Solvency II, and it is worth remembering that Basle II deems mortgage lending to be less risky, and therefore to require a lower capital density, than regular commercial banking. The reason for this attitude is to be found in the relatively low default rate on domestic mortgage lending and the fact that rising house prices usually means that repossession and sale recovers most, if not all, of the bank's outlay when serious default does occur.

On the other hand domestic mortgages are traditionally for lengthy periods and so lead to a different type of exposure, the one that arises because depositors – the traditional source of funds for lending – may recover their money either at call or short notice. Now borrowing short and lending long may look, on the face of it, like a bad idea, but it is what bankers do and it is how they have grown into vast and wealthy institutions over time. Insurers, for their part, daily put prices to products without knowing their cost of production; something that may look crazy to a manufacturer, but a practice from which insurers have prospered nonetheless. Both disciplines get things wrong from time to time. Bankers got things badly wrong in the 1980s, lending to developing countries in the belief that a sovereign power could not default. Certain underwriters at Lloyd's (and outside Lloyd's too) seemed to think that risks could be repackaged and recirculated indefinitely so that somehow no one would be holding the parcel when the music stopped. This gave rise to the notorious LMX debacle that caused the ruin of many Lloyd's names.

It may be worth sticking with the LMX issue for the moment because it has parallels with the September 2007 US sub-prime lending crisis. In the same way that sub-prime mortgages were packaged up and sold on to other institutions, thereby taking the risk off the balance sheet of the originating bank, so in London risks underwritten by one syndicate where repackaged in the form of whole account stop loss protection and passed on to others. When things start to go wrong – in the case of insurance when major loss events occur – the main problem becomes working out where these losses will ultimately fall. An underwriter might not have known of any exposure to, for example, Piper Alpha, because it was obscured as part of the whole account reinsurance of another syndicate that had written whole account stop loss for yet another syndicate that had regular reinsurance exposure to the oilfield disaster. In practice there might have been many more iterations. This meant that it would be some time before the spiral of losses unwound

sufficiently to show who was really exposed to what. Not at all what should happen in a business where underwriters are supposed to understand the basis risk that they are running. It is this fear about not knowing where the land mines are to be found that brought paralysis to interbank lending in more recent times.

Are there any lessons for insurers in what ultimately caused the crisis at Northern Rock?

We think that there are, at least, some parallels. Banks don't rely on capital to provide funds for lending, they rely on deposits in the same way that insurers rely on premiums to pay claims. They have to manage the short/long risk, mentioned above, but things usually go wrong for them when they make bad lending (or financing) decisions. This was certainly the issue with the sub-prime lenders, although whether this was an example of poorly managed operational risk or the application of a faulty strategy remains to be seen. We suspect that it was a combination of both, with a risky strategy (which is not necessarily the same thing as a bad strategy) poorly defined and then recklessly executed. But Northern Rock, at least by common view of the media, did not fail in the execution of a sound lending approach, and yet things still went wrong in operations. Quite simply it appears to have failed to appreciate even that there was a risk that its very short-term method of raising finance could fail. Might something similar happen in insurance?

Catastrophe risk is an area where the capital markets are becoming involved in insurance risk transfer. Increasingly sophisticated bonds may be issued to provide a form of protection to insurers or reinsurers in respect of large loss events. The capital markets are said to be becoming more keen on this business because it offers no exposure to contagion from other types of risk to which they may be exposed. Now let us suppose that an enterprising insurer saw the opportunity to make large profits by writing a lot of catastrophe risk and laying it off in short order by issuing catastrophe bonds. Risks like hurricane and flood being considered seasonal, there may be felt to be no need to rush to arrange protection until the extent of the business actually written became clear. But then suppose that, at the crucial point, the capital markets, for whatever reason, suddenly lose their appetite for catastrophe risk. What happens now?

Although the insurer will be under no immediate cash pressure, because a loss has yet to occur, it is clearly in a very vulnerable position, notwithstanding that its risk selection and pricing were both sound. A proper assessment of the possibility of operational failure, in the form of the disappearance of a market, may well have led to the conclusion that the bonds should have been arranged in advance (leaving, of course, the risk that not sufficient business might then be written to justify their cost).

Whatever the capital this hapless insurer may hold it is unlikely to go far should a major insured event occur without recourse to reinsurance protection, remember that Northern Rock's tier 1 capital was considered more than sufficient for a mortgage bank. We have said it before and make no apologies for repeating it: the vast bulk of failures are not due to a lack of capital but to a failure in managing operational risk.

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