

# Operational Risk The Zurich Way

How the program was developed,  
background, challenges overcome,  
challenges remaining, etc.

*"When did Noah build the Arc  
Lois? Before the rain, BEFORE  
the rain." Spy Game.*

# Introduction – why do this

- The two main **areas of benefit**:
  1. **Operational** – a desire to further improve transparency and ownership of risk and to improve the quality of risk information available for strategic and operational decision making
  2. **Financial** – a need to improve the active management of our Operational Risk Based Capital (RBC)

Supported by

- **Improved quality** and **cost saving** in terms of capital costs and reduced loss events.
- **Increased attention from stakeholders** on good operational risk management practices
- **New regulatory requirements** on operational risk management for insurance companies (i.e. SST, Solvency II)

# Operational Risk The Zurich Way

Background to what developed

*“Wise men say, and not without reason, that whoever wished to foresee the future might consult the past.”*

*Machiavelli*

## Starts at the top

“....a global financial services company of our size must manage its risks comprehensively....risks impacting our assets are in many ways different from the insurance risks affecting the other side of the ledger. But in the end, we must arrive at an integrated view. This point is shared by rating agencies and regulators, two important partners in the risk dialogue. Our response to these challenges consists in a further strengthening of our risk management function and in developing an enterprise-wide framework.”

*Jim Schiro's speech at the Annual General Meeting, April 20, 2006*

# Elements of Operational Risk Management

- Over the years Zurich has managed Operational Risk through different functions, however, the Group has not had a comprehensive framework for managing Operational Risk
- Zurich's current initiative led by Group Risk Management adopted the Basel II definition with one amendment

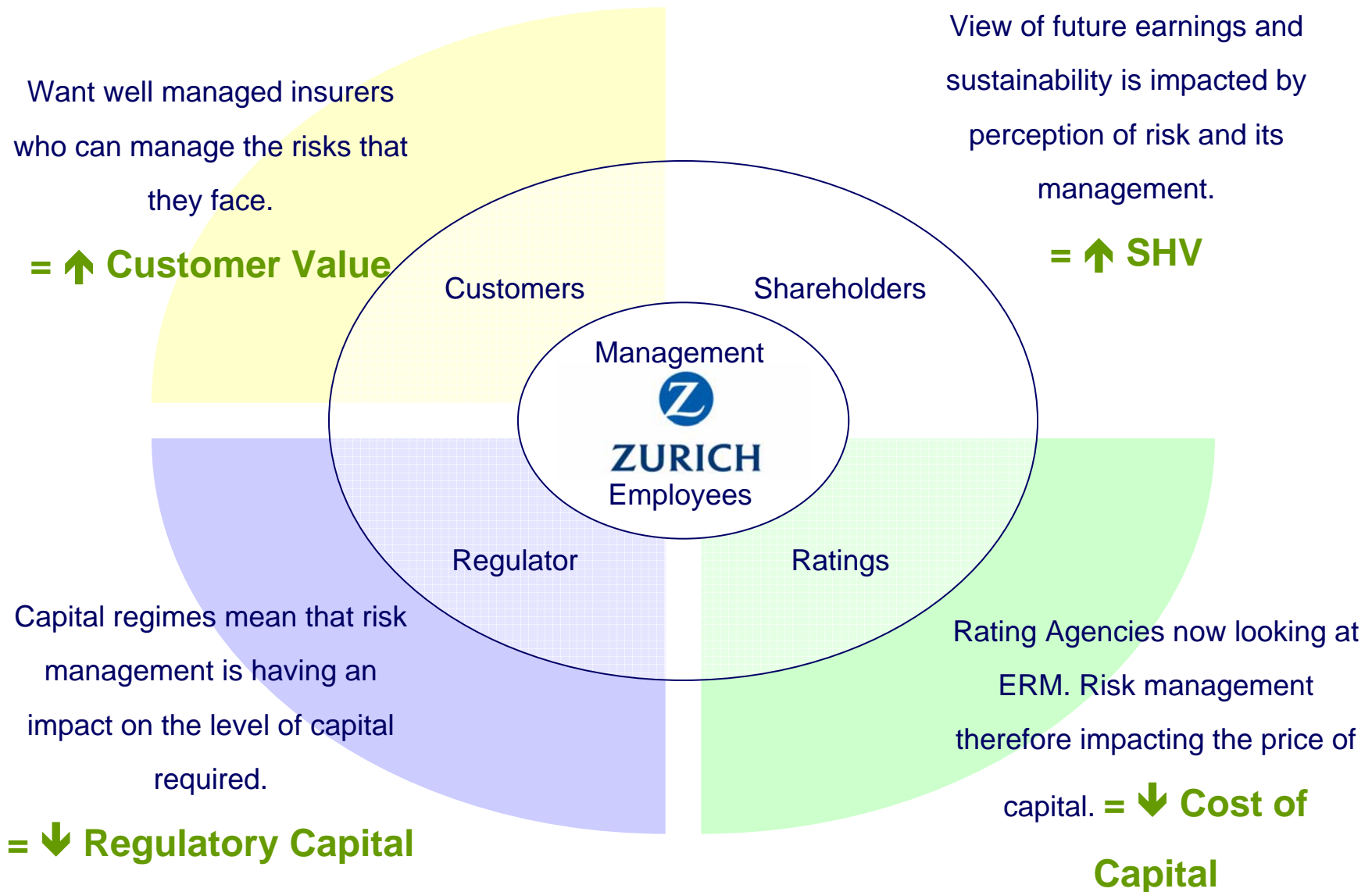
## Definition of Operational Risk

Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.

This definition includes legal risk (1), but excludes strategic and reputational risk as well as risk arising from claims fraud.

(1) Legal risk includes exposure to fines, penalties, or punitive damages resulting from supervisory actions, as well as private settlements.

# Benefits to our Stakeholders = value to us



## Cost of risk

= expected loss + cost of capital

## Benefit of risk management

= ↓ EL + ↓ CoC

# Benefits - Operational

Refresh the operational risk management **culture**:

- Build on **formalized processes**
- **Assign ownership** of risks and improvement actions
- Define **roles and responsibilities clearly**
- Ensure a consistent approach across the Group to **shared mindsets** and behaviors globally based on a **common language** and common metrics

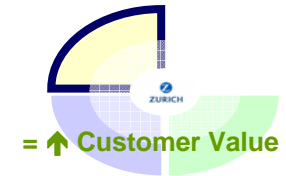
Benefit for **Local management**

- **Avoid** unexpected operational **losses** by better managing operational risks
- **Provides tools** to managers to manage and track their risks and risk management actions
- Increases the chance of **achieving business objectives**
- Culture of **transparency** and clear risk **ownership**

**In addition for senior management**

- **Embedding of responsibility** to manage operational risks into existing management process and **increased awareness** of operational risks promotes **risk based decision making**
- **Consistent, effective and efficient** approach to manage and report on operational risks across the company

# Benefits - Customers



- Improved customer service quality.
  - For an insurer, one example would be better control over the setting of terms and conditions, which can minimize disputes in claims paying. A knock-on effect of improved customer service quality would be increased customer retention.
- Another customer benefit would be more confidence in the insurer due to increased financial stability and operational control.
- Its also linked to our DNA (**solid**, engaged, world-wise, **agile**, challenger) and brand positioning particularly around:
  - financial strength
  - trustworthy
  - expertise

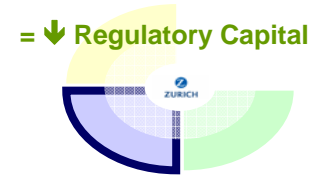
# Operational Risk The Zurich Way

Regulators and Rating Agencies

*“Risk comes from not knowing  
what you`re doing.” Warren*

*Buffett*

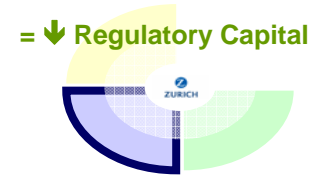
# Benefits - Regulators



- When introducing the new capital rules in 2002 the FSA said:
  - "The main benefits of this proposed framework are that it meets our overall aim of **reducing the probability of prudential failure**, in a cost efficient way that **creates greater transparency** in the arrangements for setting regulatory capital levels, while at the same time promoting a **strong culture of risk management.**"
- In the Financial Risk Outlook 2006 they indicate further work is required:
  - "General insurers have also been subject to our new ICAS regime since January 2005. Although firms' risk-management frameworks generally **appear to be improving**, their depth of analysis and use of quantitative techniques in determining their individual capital assessment have varied widely, largely reflecting the diverse nature of the general-insurance industry."
- The FSA's new ARROW Framework indicates a lighter touch for good risk managers:
  - "By taking a more overtly risk-based approach to our assessment of whether firms are operating in line with these principles we can create incentives for firms to do the right thing in return for a **regulatory dividend** – that is less regulatory intervention." (Draft document at present)

# New Regulatory Regimes (1)

## *Treatment of operational risks*

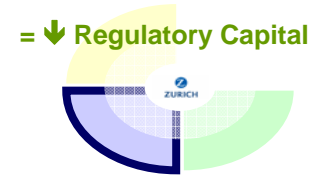


### Swiss Solvency Test

- In spring 2003 the Federal Office of Private Insurance initiated the Swiss Solvency Test (SST) project with the aim of defining basic principles of a future system for determining solvency.
- New regulation is effective since 01.01.2006; currently insurers conduct mandatory field-tests and have time to build up capital until end of 2007
- Insurance, market, credit and group risks have to be assessed quantitatively, liquidity and operational risks only qualitatively -> **No capital requirement for Op Risks but**
  - Supervisory authority requires efficient internal risk management systems
  - Risk management is monitored via a structured self-assessment questionnaire that every insurance company is required to complete
  - The supervisory authority will discuss the self-assessment with the insurance company at least every three years

# New Regulatory Regimes (2)

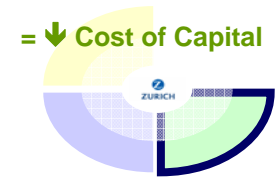
## *Treatment of operational risks*



### Solvency II

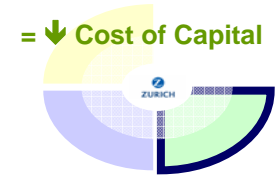
- The European Union is currently developing the framework directive under the patronage of the European Commission
- The first draft is expected for mid 2007 and Solvency II might become effective from end 2009 onwards
- Solvency II requires a quantitative assessment of operational risks and evaluates calculation methods as part of the ongoing Quantitative Impact Study (QIS 2) -> **Capital requirement for Op Risks:**
  - Simple factor based formula: Take the maximum of (6% of earned life premiums + 3% earned non-life premiums) and (0.6% life provisions + 3% of non-life provisions + 0.3% of health provision)
  - Risk sensitive formula: 1.5% of assets + 0.25% of outsourced assets + 0.03% of total provisions + 5% total annual expenses + 1% of external expenses + 1000\* number of staff\*(1+ 0.04\*number of parent undertakings)\*( 1+ 0.02 \* number of subsidiaries)
  - Premiums and provisions are taken gross of reinsurance
  - Insurers are requested to provide internal results as well (if available)

# Benefits - Rating Agencies



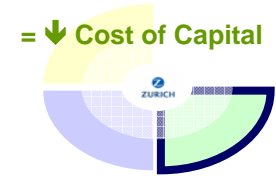
- *“Standard & Poor's Ratings Services has always strongly emphasized an insurer's risks and how they are managed when forming an opinion of that insurer's financial strength or creditworthiness. Beginning in October 2005, we strengthened our emphasis further when we added a formal evaluation of insurer enterprise risk management (ERM) capabilities to the rating process.”*
- *“Strong ERM insurers have exceeded the Adequate criteria for risk control and have a vision of their overall risk profile, an overall risk tolerance, a process for developing the risk limits from the overall risk tolerance that is tied to the risk-adjusted returns for the various alternatives, and a goal of optimizing risk-adjusted returns. In addition, Strong programs have robust processes to identify and prepare for emerging risks. Standard & Poor's expects ERM to be a competitive advantage for these insurers over time.”*

# S&P's Operational Risk Criteria (1/2)



	Most Favourable	Least Favourable
<b>Risk identification</b>	Risks identified using industry and company experience, as well as <b>top-down and bottom-up processes</b> . Focus is on <b>high-priority risks</b> .	Operational risk efforts focus only on recent industry losses. Bottom-up process for risk identification. No focus or prioritization.
<b>Risk monitoring</b>	Insurer uses <b>key risk indicators</b> closely tied to actual risk. Indicators are summarized and receive attention from management	Risks are not monitored.
<b>Risk limits and standards</b>	Insurer has <b>documented and comprehensive compliance standards</b> .	Compliance is reactionary, solely addressing the most recent problem area.
<b>Risk management</b>	<b>High-level manager identified to own each priority risk</b> . That manager is responsible for reporting successes and failures in managing the risk as well as identifying weaknesses for future improvement.	Risk ownership unclear. Risk management improvement plans are primarily after losses.
<b>Internal control process</b>	<b>Proactive internal control processes go beyond internal audit emphasis on financial controls</b> . Clear duties and reporting lines. Top-down and bottom-up approach.	Little or no identification or quantification of operational risks. Some categories have few or no internal control processes. Existing process focus. Passive, top-down-only box-checking approach. Blurred responsibilities.
<b>Regulatory and compliance risks</b>	<b>Appointed compliance officer</b> . Regular reporting of achieved compliance. <b>Good regulator relationships</b> . <b>Codes for conduct/ethics/</b> money-laundering programs. Whistle-blowing encouraged.	Compliance responsibilities allocated unclearly or not at all. Problems with regulator and stock exchange (if public). Unexpected regulator involvement.
<b>IT risk</b>	<b>IT risks identified and quantified</b> . Documented IT <b>strategy and procedures</b> . <b>Checks</b> on system security, data integrity, new systems testing, and backup facilities.	Informal or incomplete potential IT risk identification. Inconsistent data, inaccurate analysis, security breaches, mismanaged IT projects, or system failures.

# S&P's Operational Risk Criteria (2/2)



	Most Favourable	Least Favourable
<b>Human resources risks</b>	Documented <b>HR strategy and procedures</b> . Pre-employment <b>screening</b> . <b>Succession planning</b> . Proactive training policies and records. Externally funded pension liabilities. Whistle-blowing encouraged.	Limited, informal, undocumented HR policy. Inconsistently applied across business units. Key-man dependency. Industrial/employee relations problems, absenteeism, employee dishonesty, difficulty attracting and retaining personnel. Large balance sheet pension fund deficit.
<b>Distribution risks</b>	<b>Maintains list of authorized intermediaries with documented procedures</b> covering required expertise and culture characteristics, vetting procedures, contract terms, and authorized limits. <b>Monitoring of activities</b> .	Unclear identification of distribution risks. Failure consequences not quantified. History of fraud or mis-selling by company or intermediary. Delays in receipt of monies owed to company.
<b>New projects and acquisitions</b>	Risks arising from M&A, change management, and projects are identified and quantified in advance as part of standard procedures.	Possible M&A or other risks not assessed or quantified in advance. Inadequate due diligence.
<b>Reputation risk</b>	<b>Reputation risks identified and quantified re potential sources and consequences</b> . Crossover with other risk areas. Established crisis management procedures, including media training.	No identification or quantification of possible reputation risks. Brand damage due to previous failures of strategy, governance, systems, or controls. High customer complaint levels.
<b>Outsourcing risks</b>	Maintains <b>list of authorized suppliers and documented procedures</b> for contract terms and authorized limits. No exclusivity.	Limited contractual recourse. Single supplier dependence. Absence of documentation.
<b>Risk learning</b>	<b>Robust processes to analyze loss situations and quickly adjust policies, procedures, and standards</b> .	Limited loss analysis. Tendency to put bad experiences aside immediately.

# Operational Risk The Zurich Way

Challenges faced

*“Real valor consists not in being  
insensible to danger; but in being  
prompt to confront and disarm it.” Sir*

*Walter Scott*

## Challenges faced (1/2)

- Operational risk is an entity wide subject. Consequently to achieve change on this subject it is necessary to adopt clever ways to effect change or you risk “boiling the ocean”.
- Many of the key operational risks are already covered by separate programmes activities. You need to work with these areas (Fraud Management, Compliance, Business Continuity, IT Security, Claims Fraud, etc.) to pull together an integrated view.
- Management time and bandwidth - make it easy and use the time wisely.

## Challenges faced (2/2)

- Capital number v operational and cultural aspects – Don't forget that both pillars are important.
- US (particularly Sox) v Europe.
- Transparency v the law – is the data you collect a lawyers playground?
- Risk v controls – if you have a control framework why do you need operational risk management as well?