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# Session D7: The Crossover between Insurance Risk and Operational Risk

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# The Crossover between Insurance Risk and Operational Risk

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# Session overview

- Understanding the crossover between risk categories lies at the foundation of developing mature risk management practice
- If it is unclear that an operational risk loss event is impacting another type of risk exposure (e.g. insurance risk):
  - management responses may not adequately reflect all the risk
  - risk measurement may misrepresent the risk exposure
- The insurance risk - operational risk (IR-OR) boundary deserves greater attention from insurance firms, because it can inform actions to reduce risk and optimise capital



# Agenda

- The need to understand the IR-OR Boundary
- IR-OR Boundary Research and Findings
- Case studies - Breakout session and feedback
- Conclusions
- Way forward
- Questions



# The need to understand the IR-OR boundary

- As operational risk is one of the main categories of risk to which an insurance company is exposed, it is important there is a clear understanding of the boundaries between operational and the other categories of risk, so that each can be managed and measured appropriately
- The definition of the boundary between operational risk and insurance risk has been identified by the Insurance Industry as a fundamental issue in:
  - the consistent management of risk
  - the collection and modelling of operational risk loss data
  - though modelling was not seen as being the driver



# The Research - Objectives

- ORX partnered with KPMG to:
  - establish what current industry practices are for the identification and management of risk events lying on the boundary between operational risk and insurance risk
  - identify convergent practice and to use this as a basis for discussions about future Insurance Industry standards
- ORX found insurers from around the World to participate:

Ageas	Assicurazioni Generali SpA.	Manu Life	Talanx AG
Allianz	Commonwealth Bank of Australia	Munich Re	TIAA-CREF
AXA	Hannover Re Group	RBC Insurance	UnipolSAI
AWAC	Liberty Group	Swiss Re	Zurich Insurance



# The Research - Approach

Comprised of two parts:

1. Benchmark survey to gather information and data on:
  - Risk definitions used by the respondents
  - How IR-OR boundary events are managed
  - The internal experience of IR-OR boundary events
  - Categorisation of events possibly on the IR-OR boundary
2. Roundtable Discussion for participants to discuss survey results and identify areas for developing industry practice:
  - Recommend a definition of a boundary event
  - Propose a process to facilitate how to identify IR-OR boundary events
  - Provide examples of boundary events to increase awareness and consistency



# The Research - Findings: Why the IR-OR boundary is important

- The boundary should be of interest to all management disciplines within insurance companies, not just the Risk Function:
  - Research participants thought approximately 40% to 50% of operational risk events are likely to be IR-OR boundary events
  - It is important to know if an event is on the IR-OR boundary and to assess its financial and non-financial impact
  - A good understanding of risk boundary events could help reduce avoidable losses and therefore greater scrutiny and understanding of them should ultimately improve outcomes
  - Flagging IR-OR boundary events can help avoid over or under-estimating the operational and insurance components of insurers' risk capital models



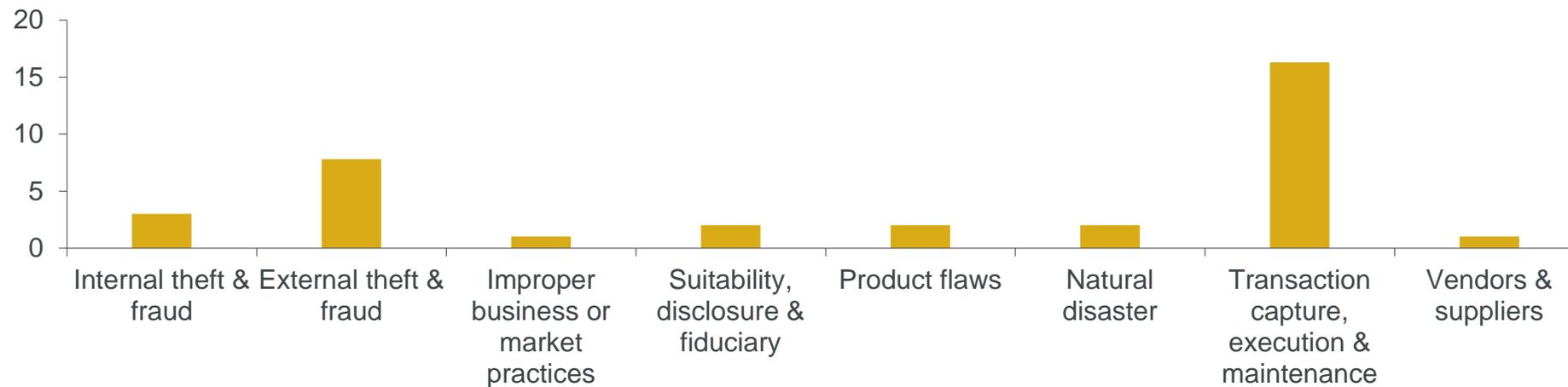
# The Research - Findings: Definitions

- Risk definitions are essential tools used in identifying and then categorising different risk events and in designating the boundaries between them:
  - Operational Risk - the Basel II/Solvency II definition of operational risk is widely used
    - but less consistency in definition of operational risk categories
  - Insurance Risk – greater inconsistency in definitions and categorisation (life and non-life)
    - but frequent reference to loss and adverse change in the value of insurance liabilities
- Consistent identification of IR-OR boundary events across the Industry needs consistent risk category definitions, but:
  - Categorising events into risk categories is not straightforward and requires a set of well understood risk category and boundary definitions
  - Only half the firms had their own definition of an IR-OR boundary event



# The Research - Findings: Internal experience of boundary events

- The most common categories of boundary risk events reported were:
  - Transaction Capture, Execution & Maintenance
  - External Theft & Fraud



A better estimate of the % of operational risk events on the insurance boundary needs a clear definition of risk categories and consistent data collection



# The Research - Findings: Boundary risk definition

General consensus that the Insurance Industry would benefit from a consistent definition of a boundary risk event

*An operational risk boundary event is an operational risk event which triggers a consequence (e.g. financial loss) in another risk category*

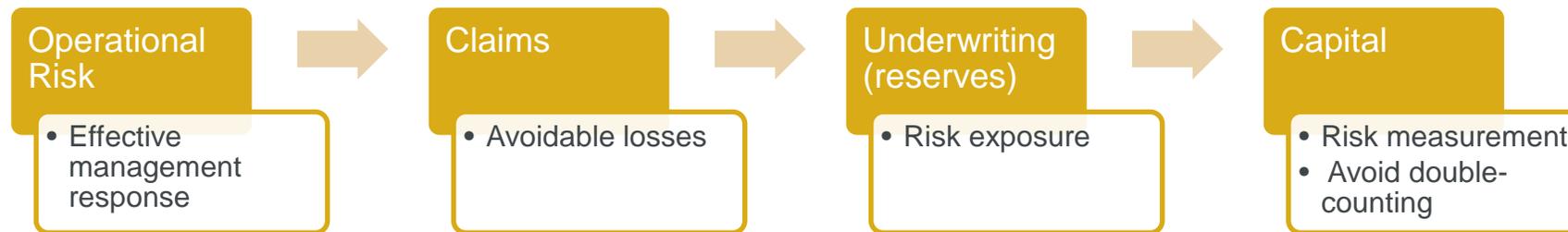


*An insurance risk - operational risk boundary event is an operational risk event that triggers an insurance risk consequence (e.g. a financial loss)*



# The Research - Findings: Realising the value of identifying boundary events

- Understanding risk events better, should lead to better remedial management actions, reduce avoidable losses and reduced capital requirements
- An example of a well-described boundary event cited was an insurance product, whose design made it vulnerable to fraud, which was driving-up expense risk:
  - Examination of the detail of the product’s operational losses revealed what action could be taken by the insurance firm to improve the product and reduce instances of fraud
  - If fraud had been properly considered as a manageable factor driving insurance risk, then remedial action might not have been required



# Case study

## Insurer pays settlements totalling \$501.5 million over unpaid life insurance payments

- The insurer reached an estimated \$500 million settlement in a multistate investigation of unpaid life insurance and annuity benefits
- The Insurer possessed information about the deaths of life insurance policyholders, available through a government administered death database, but did not pay out related benefits
- The settlement is reported to comprise \$438 million in payments to policyholders and beneficiaries and \$40 million in costs.
- In 2014 the Insurer announced it settled out of court and agreed to pay the State \$1.5 million and conduct a review of payments to all its policyholders who died between 1986 and 2012 – a 16 year period. It also consented to find and pay the necessary proceeds to all beneficiaries and improve its processes to ensure beneficiaries are in future remunerated within the correct timeframe.

### Operational Risk Event

- Transaction, capture, execution & maintenance

### Insurance Risks

- Longevity Risk, Claims Risk and Expense Risk

### What lessons did the Insurer learn?



# Breakout Session

Questions:

1. Is there an IR-OR boundary event?
2. What is the insurance sub-category on the boundary?
3. How would you become aware of such an operational risk event at your firm?
4. What would you do differently to avoid a similar situation arising?

*The following case study is a publicly reported operational risk loss event sourced from ORX News*



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# Breakout Session - Case study

## Insurer alleges a \$7.6 million insurance fraud involving fraudulent claims for care

- A rehabilitation centre allegedly took advantage of a State law that mandates that for people injured in road accidents there are no medical benefit caps for an unlimited period. Consequently the rehabilitation centre carried out an aggressive and extensive marketing campaign to recruit patients within the State.
- It exploited the opportunity to make unlimited claims on insurance by keeping these patients as long as possible, admitting some patients who should not have been at the facility in the first place, billing for treatments that were not medically necessary, and, in some cases, providing little or no treatment at all. There were even suggestions that the rehabilitation centre attempted to stop patients leaving their centre through a combination of threats and incentives.
- In the ensuing lawsuit initiated by the Insurer, there was an example of a child hurt in a motorcycle accident who spent 6 years at the rehabilitation centre at a cost of \$1.8m, but that the child rarely received treatment and, considering other medical conditions that he had, should perhaps not have been at the rehabilitation centre at all.
- To hide the alleged fraud scheme, the Insurer claimed the rehabilitation centre falsified medical records, invoices, bills and other insurance claim documents and demanded per diem contracts to avoid having to itemise bills. The Insurer also claimed that, as the State law required it to pay the bills within 30 days of receiving them, it had little time to question any charges.



# Conclusions

- The IR-OR boundary deserves greater attention
- It can inform actions that will reduce risk and capital
- Current practice in identifying the boundary is inconsistent and should develop
- The participating experts agreed they should increase awareness of IR-OR boundary events in their businesses
- This needs to be executed in a practical manner

More detail of this research is available in the ORX/KPMG Research Report 'Defining the boundary: An industry-wide appraisal of the operational risk-insurance risk boundary'

Copies can be obtained from ORX: please email [enquiries@orx.org](mailto:enquiries@orx.org)



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# Way forward

- Finalise an agreed boundary risk event definition
- Set out a methodology for their identification and assessment
- Build a library of supporting examples and case studies



# Questions

# Comments

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