

Legal Risk: The Operational Risk Problem in Microcosm

- The Nature of Legal Risk
- The Insurability of Legal Risk
- The Securitization of Legal Risk

The Nature of Legal Risk

- Difficult to define: losses that depend on how the law allocates risk between financial institutions and other transactors or the government
- Difficult to predict but determines whether bank actually bears the losses of an operational failure
- Wide ranges of frequency and impact for different kinds of legal risk

A Sampling of Court Cases

- Sample of decided cases in federal district courts and three state appellate courts, October 1, 2000 - October 1, 2001
- Not a reliable sample: only includes litigated cases that were not settled, and only deals with a short period of time
- Purpose: show the variety of different cases in federal court and the difference in legal environment among states

Federal District Court Cases

October 1, 2000 - October 1, 2001

<u>Type of Case</u>	<u>Number</u>
Banks as Trustee	4
Antitrust	2
Checks	9
Consumer Protection	54
--Truth in Lending	21
--Fair Debt Collection	9
Contracts	31
Discrimination	24
--Customer	6
--Employees	18
Fraud	15
Holocaust Compensation	1
Indian Land Claims	2
Mortgage or Foreclosure Dispute	8
Patent Infringement	2
RICO	10
Securities Fraud	17
--Fraud	8
--Disclosure	9
Third Party	32
--Deposit Holder or Trustee	18
--Finance Provider or Debt Holder	4
--Mortgage or Lien Holder	10
Torts	4
Trademark	2
Other	<u>7</u>
TOTAL	224

State Court Appellate Cases

October 1, 2000 - October 1, 2001

<u>Type of Case</u>	California	New York	Texas
Banks as Trustee	3	0	4
Checks	1	4	7
Consumer Protection	1	0	5
Contracts	1	9	13
Conversion	0	1	4
Employment Discrimination	2	3	0
Fraud	0	4	5
Mortgage/Foreclosure	1	1	2
Personal Injury	0	10	1
Securities	0	0	2
Third Party	2	9	8
Other	<u>1</u>	<u>1</u>	<u>4</u>
TOTAL	13	41	55

Material Litigation of Top 100 Banking Companies, 2000

- 21% reported specific litigation in 10k
- **Actions against Banks**

<u>Type of Case</u>	<u>Number</u>
Breach of Fiduciary Duty	
Consumer Protection	6
Conversion and Fraud	2
Derivative Suit	2
Employment	1
Environmental	2
Lender Liability	1
Merger Related Suits	2
Patent Infringement	1
Securities Violation	3
Unspecified	<u>1</u>
TOTAL	24

- **Actions by Banks**

Goodwill Claims	4
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The Insurability of Legal Risk

- Insurance Products
- Extent of Insurance Coverage
- Dependability of Coverage

Insurance Products and Extent of Coverage for Legal Risk

- Bankers Blanket Bond or Financial Institution Bond
- Computer Crime Policy
- Unauthorized Trading Policy
- Property Insurance Policy
- Bankers Professional Indemnity Policy
- Commercial General Liability Policy
- Employment Practice Liability Policy
- Directors and Officers Liability Policy
- Electronic Insurance Policy
- Environmental Protection Liability

Dependability of Insurance for Legal Risk

- Quite dependable for non-major repetitive claims
- Less dependable for major losses: World Trade Center example
 - Assume a financial institution owned the WTC
 - Insurance was \$3.5 billion “per occurrence”
 - Replacement value of WTC is over \$5 billion
 - Amount of loss depends on whether there was one occurrence (one terrorist attack) or two occurrences (two planes and two different buildings collapsed)
- Issue is legal risk of insurance coverage itself

Securitization of Legal Risk

- Cat bonds a small market
- Legal Risk Cat Bonds quite unlikely because legal risk does not represent a clearly defined event with an actuarial history like a hurricane or earthquake
- If they existed, like Cat Bonds today they would be issued by insurance companies, particularly reinsurance companies, not by banks or bank holding companies.
 - So this would not generally affect Basle II
 - It would affect regulators of the capital of insurance companies

Legal Risk: Conclusions

- The Nature of Legal Risk: very hard to define
- The Insurability of Legal Risk: partial, extent unknown, may not be dependable for very large losses
- The Securitization of Legal Risk: not generally an issue for banks
- Setting aside any level of capital for legal risk is largely guesswork for major risks, as it is for operational risk generally: **USE PILLAR TWO**