

Understanding High Severity Losses

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Overview

- Review high severity losses by geographic region.
- Discuss high severity losses in the US LDCE.
- Discuss implications for risk management and policy.
- Conclusions.

National Differences – Same External Data Source

US losses

1. CorpF CPBP
2. RetBro CPBP
3. RetBro CPBP
4. CorpF CPBP
5. RetailB CPBP
6. CorpF CPBP
7. CorpF CPBP
8. RetBro CPBP

Japan losses

1. ComB EF
2. RetBro IF
3. RetailB IF
4. ComB EF
5. RetailB IF
6. Trading IF
7. RetBro CPBP
8. RetBro CPBP

EU – Between Extremes

EU losses

1. Asset IF
2. RetailB CPBP
3. ComB CPBP
4. ComB CPBP
5. ComB EF
6. RetailB CPBP
7. RetailB EDPM
8. Asset IF

- Top 8 US losses, at time of incidence, are all \$1.7 billion or above.
- Top 8 Japanese losses, at time of incidence, are all below \$1 billion.
- Of top 8 EU losses, at time of incidence, half are above \$1 billion and half are below \$1 billion.

US Observations

- Largest losses are more severe than EU and Japan.
- These losses generally are in clients products and business practices, which captures lawsuits.
- Legal actions tend to be in corporate finance – tied to activity with clients and retail activities – and result from class action lawsuits.
- Modeling business line activity in the US for the tail of the distribution will be dominated by modeling legal liabilities.
- Many of the high severity losses are recent.

Japanese Observations

- Internal and external fraud are the main sources of tail events.
- Few lawsuits – clients, products and business practices tends to be from tax disputes.
- Commercial banking accounts for many of the high severity losses, corporate finance is far less prevalent, in part, because of fewer lawsuits.

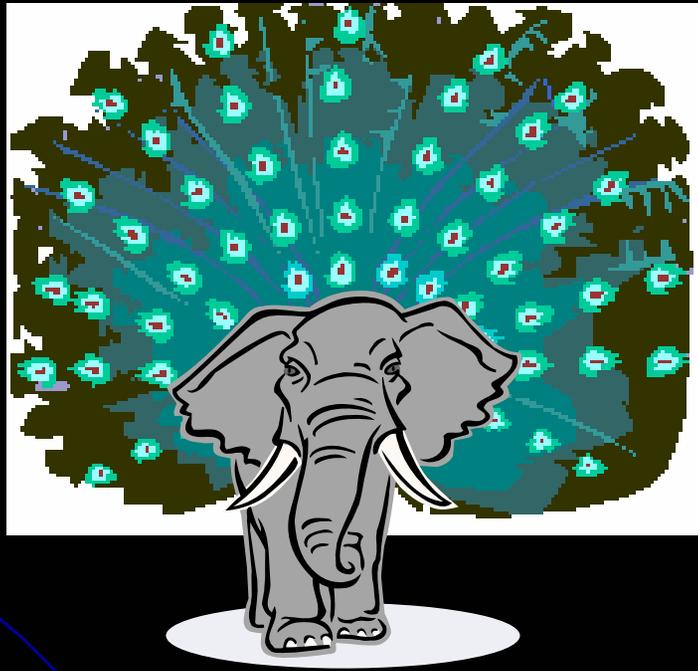
EU Observations

- More high severity losses in commercial banking than in the United States.
- More CPBP than in Japan – More prevalence of lawsuits.
- Corporate finance does not have the high severity losses of the United States.

General Observations

- Payments and settlement not among the 15 largest losses in any of the regions.
- Employment Practices and Workplace Safety and Business Disruptions are not among the 15 largest losses in any of the regions.
- High severity losses appear to have distinct regional patterns.

External Data: It Is A Challenge To Correctly Identify The Tail



LDCE – US Data

- Legal losses are gross of taxes in the LDCE but are frequently listed as net of taxes in external data.
- Legal losses are frequently listed as other or multiple in LDCE while they are assigned one business line in external data.
- Announcements of legal reserves frequently pool losses to prevent assessment of individual events.
- LDCE includes data from 23 participants while external data covers a wider variety of institutions.

LDCE

- Among 20 largest losses – 11 in other, 4 in trading and sales, 3 in retail banking and 2 in asset management.
- Among 20 largest losses – 16 in clients products and business practices, 2 in external fraud and 1 each in damage to physical assets and business disruption.
- Lawsuits in CPBP appear to be in other category in LDCE instead of in corporate finance or retail areas.

LDCE Observations

- Many high severity losses have significant multi-business line attributes. The use of other rather than a business line highlights classification difficulties.
- Of the 20 largest losses, more than 90 percent of the value of those losses were in clients products and business practices.
- Of the 20 largest losses in several external data bases for the US the value was closer to 70 percent.

Comparison Across Data Bases

- By causal type, external data and LDCE data are quite similar.
- By business line, classification in external data and LDCE can be quite different.
- Most differences in amounts and timing conventions appear to be from differences in pre-tax/after-tax reporting and the timing of reporting of legal losses.

Policy Implications

- Event type modeling may be easier than business line modeling because losses may be more consistently categorized, particularly when mixing internal and external data.
- Misclassification of high severity losses can make large differences in assigned capital.
- Calculation of business line betas from data may be affected by reporting problems.
- Betas may be different across countries because of the different sources of high severity losses.

Implications for Risk Management

- US – Risks to new product lines should be fully understood – particularly legal risk.
- For large US losses, many of the practices were well known, but the risks were not fully appreciated.
- Legal risk mitigation – be aware of future legal risk – common practice is not a good defense.

More Implications for Risk Management

- Global banks need to understand differences in high severity losses by jurisdiction.
- Most high severity losses for the industry have been concentrated in a few business lines and event types.
- More work needs to be done on understanding legal risk.

Future Work on High Severity Losses

- High severity losses tend to be in a few business lines and causal types – more focused work on causes of these losses is needed.
- High severity losses may vary significantly by jurisdiction.
- Many key risk indicators are focused on high frequency losses and may not be as appropriate for high severity losses.
- More work needs to be done on how scenarios can be informative of potential tail events.