Objectives

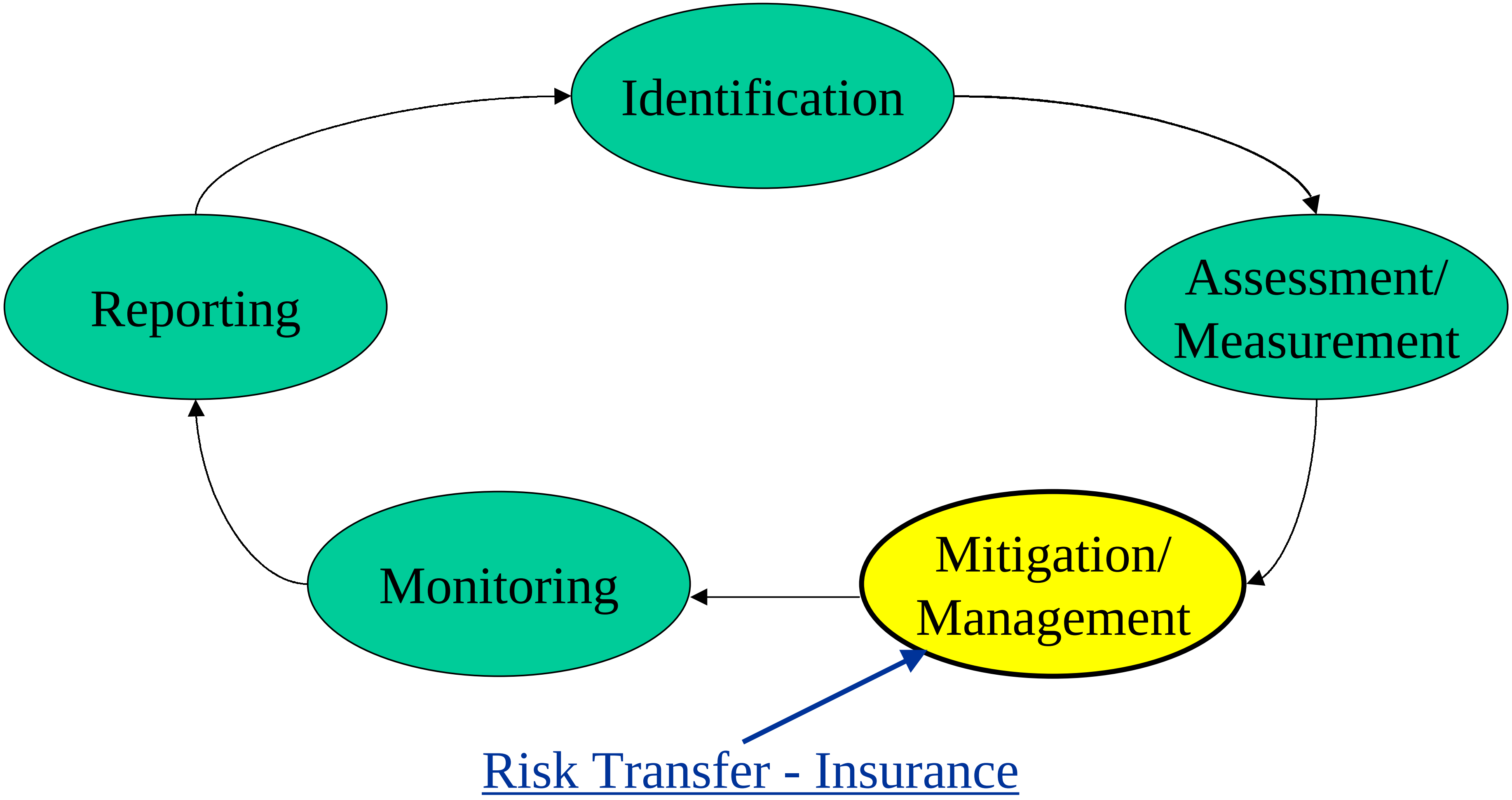
- Discuss role of insurance in operational risk management.
- Provide overview of insurance market for operational risks.
- Outline reasons for including insurance in the New Basel Capital Accord.
- Offer recommendations for how to incorporate insurance in the New Basel Capital Accord.

Insurance of Operational Risk and the New Basel Capital Accord

Presentation Outline

- Role of insurance in risk management framework.
- Overview of Insurance Market for Operational Risks
- Insurance and the New Basel Capital Accord

Operational Risk Management Framework



Framework adopted from “Operational Risk Regulatory Approach Discussion Paper”, ISDA, September 2000

Risk Transfer

Exchange unknown financial impact of specified events to a third party for a known financial cost.

- Insurance
- Securitization
- Other

Risk Mitigation/Management Objectives

Objective	Reduce Probability of Event (**Frequency**)	Reduce Economic Impact of Event (**Severity**)
Strategies	Internal Controls	Internal Controls Recovery/Continuity Planning Risk Transfer (Insurance)

Importance of Risk Identification

Sources of risk:

- Internal control weaknesses or lack of compliance (controllable)
- External and other (non-controllable)

Risk Transfer is critical tool
for managing exposure to
non-controllable sources of risk.

Importance of Risk Measurement

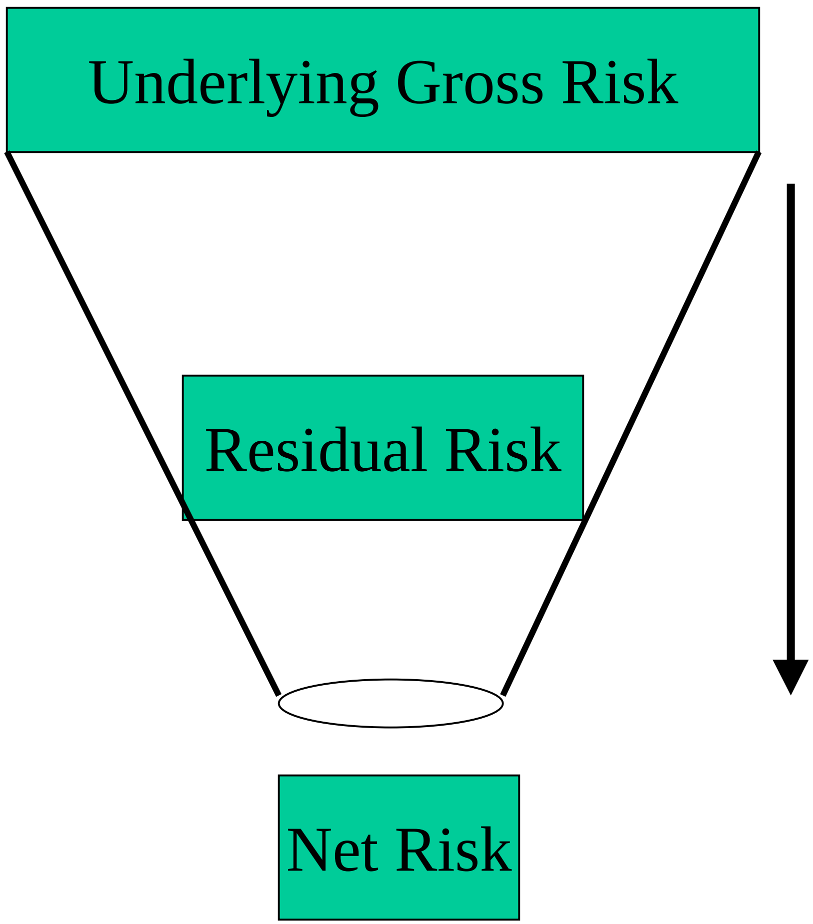
- Necessary to measure and evaluate impact of various risk transfer strategies.
- Critical to cost-benefit analysis of risk transfer decisions (coverages, deductibles, limits, etc.)

Insurance as Risk Management Tool

Direct Benefits	Indirect Benefits
- Reduces financial impact of loss.	- Loss control and risk management services provided by insurers. - External monitoring and investigation of risks by insurance company. - The cost and availability of insurance acts as incentive to reduce losses. - Causes awareness of the risks, must make decisions about what to retain and what to transfer.

RISK IDENTIFICATION

RISK MEASUREMENT



RISK MITIGATION STRATEGIES

Implement Controls and procedures to reduce and frequency and severity.

Implement Risk Transfer to reduce severity.

ALLOCATE CAPITAL

Insurance Market for Operational Risks

- Traditional insurance products
- Alternative risk transfer products
- Customized products
- Future products

Traditional Insurance Products

- Peril-specific.
- Stable, well-developed market.
- Widely available.
- Well known and understood.
- Collectively cover the scope of operational risk, (but not individually).
- Insurance industry well capitalized.

New Product Development

- Single multi-peril basket product
- Umbrella to compliment existing broader cover at a higher attachment point
- Alternative risk transfer and tailored products

New products evolve as banks needs and risks evolve.

Insurance under the New Accord

Specifically, insurance could be used to externalise the risk of potentially “low frequency, high severity” losses, such as errors and omissions (including processing errors), physical loss of securities, and fraud. The Committee agrees that, in principal, such mitigation should be reflected in the capital requirements for operational risk.

January 2001, Basel Committee on Banking Supervision, “Consultative Document on Operational Risk”

Insurance under the New Accord

Updates in September 2001, Working Paper:

- Reduced overall level of the operational risk capital charge partly to recognize the risk-mitigating effects of insurance.
- If explicit recognition of "robust and comprehensive insurance" is permitted, it should be limited to AMA.
- There should be a limit on the overall impact of insurance risk mitigation on the final capital amount.

September 2001, Basel Committee on Banking Supervision, "Working Paper on the Regulatory Treatment of Operational Risk"

Insurance and Pillar 1

"Insurance is an effective tool for mitigating operational risks by reducing the economic impact of operational losses, and therefore should have explicit recognition within the capital framework of the new Basel Capital Accord to appropriately reflect the risk profile of institutions and encourage prudent and sound risk management."

November 2001, "Insurance of Operational Risk under the New Basel Capital Accord", a working paper submitted by Insurance Companies.

Regulatory Capital

Regulatory capital treatment of operational risk should:

– recognize differences in quality of risk management and degree of risk transfer.
– encourage sound risk management within firms by clearly setting out benefits to be gained from actively managing and improving the quality of their controls and prudent use of risk transfer.
– Evolve as risk transfer market evolves.

Capital Treatment for Insurance

- Should recognize traditional insurance products as well as more comprehensive alternative forms of risk transfer.
- Should be explicit recognition of insurance under each of the continuum of approaches.
- Residual risks of insurance should be appropriately accounted for within the capital treatment (e.g. breadth of coverage, timing of payments, conditions and exclusions).

Capital Treatment for Insurance

- Should recognize the portion of risk transfer in the unexpected loss layer.
- Should have a limit to amount of relief.