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

Risk Transfer - Insurance

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

<table>
<thead>
<tr>
<th>Objective</th>
<th>Strategies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reduce Probability of Event</td>
<td>Internal Controls</td>
</tr>
<tr>
<td>(Frequency)</td>
<td></td>
</tr>
<tr>
<td>Reduce Economic Impact of Event</td>
<td>Internal Controls</td>
</tr>
<tr>
<td>(Severity)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Recovery/Continuity Planning</td>
</tr>
<tr>
<td></td>
<td>Risk Transfer (Insurance)</td>
</tr>
</tbody>
</table>
Importance of Risk Identification

Sources of risk:

• Internal control weaknesses or lack of compliance (controllable)

• External and other (non-controllable)

\[
\text{Risk Transfer is critical tool for managing exposure to non-controllable sources of risk.}
\]
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

<table>
<thead>
<tr>
<th>Direct Benefits</th>
<th>Indirect Benefits</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Reduces financial impact of loss.</td>
<td>- Loss control and risk management services provided by insurers.</td>
</tr>
<tr>
<td></td>
<td>- External monitoring and investigation of risks by insurance company.</td>
</tr>
<tr>
<td></td>
<td>- The cost and availability of insurance acts as incentive to reduce losses.</td>
</tr>
<tr>
<td></td>
<td>- Causes awareness of the risks, must make decisions about what to retain and what to transfer.</td>
</tr>
</tbody>
</table>
Underlying Gross Risk

Residual Risk

Net Risk

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.

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.

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.”

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.