May 24, 2001

Marsh, Inc. appreciates the opportunity to offer our comments on the second consultative package on the new Basel Capital Accord. Our qualifications to do so include the fact that we are the world's leading risk and insurance services firm in general and the world's leading broker to major financial institutions in particular. That experience has helped us become expert in the exposure and claims areas which are currently being viewed as Operational Risks for those institutions.

The comments contained herein are focused on the proposed regulatory capital charge for operational risk. In summary, we believe the new Accord should place more reliance on effective risk management systems and controls to mitigate operational risks and on insurance to transfer, in part, the residual risk and less reliance on experimental techniques for quantifying regulatory capital charges.

The Basel Committee on Banking Supervision has taken a constructive step in recognizing the importance of operational risks. The proposed approach, however, has fundamental flaws. First, there is too much emphasis on quantification of regulatory capital and not enough on more traditional, market based risk mitigation and risk transfer methods. Second, the proposed system is overly complex and will be very expensive to implement and maintain, and there are other alternatives that can achieve supervisory objectives at far less cost. Finally, the proposed regulatory capital charges for operational risk are too high and will create a disincentive for banks to use cost-effective risk mitigation and risk transfer solutions.

An Imbalanced Approach

In relying so heavily on regulatory capital charges to mitigate unexpected losses from operational risk, the Committee risks undermining the other two pillars of the new Accord: supervisory review and market discipline. For credit risk, supervisory review plays a critical role, and in many ways drives how the results of quantitative risk models will be used to set regulatory capital for credit risk. By contrast, under the approach the Committee is proposing for operational risk, it appears the reverse will be true. The focus will inevitably be on calibrating the quantitative models -- so determinations regarding regulatory capital will drive the supervisory process. With as much as 10 to 20 percent of regulatory capital at stake, the discussions over the quantitative models' coefficients are bound to be contentious.

Supervisors can expect many challenges to both the structure and calibration of the models they have proposed, and there will be many legitimate grounds for banks to do so. Once the coefficients are set, based on supervisors' analysis of a sample of industry-wide

loss data, there will be lots of grounds for banks to request adjustments to their specific risk parameters because of structural changes in operational risk brought about by new ways banks do business, or new technologies, or new risk management systems and controls. Unfortunately, this focus on and debate over models could shift attention away from market based solutions, such as insurance, and undermine the market discipline pillar of the new Accord.

Traditionally, the first line of defense against unexpected operational losses is an effective system of risk controls, such as trading limits, separation of duties, security measures, and anti-fraud procedures. Once appropriate controls are in place, the remaining loss exposures are frequently covered, at least in part, through insurance. Competitive forces in the insurance markets can determine the appropriate price for the risk individual banks pose. Moreover, risk pooling arrangements, such as insurance, are a more economically efficient way to handle many types of unexpected operational losses, than having each bank individually set aside capital to cover these events.

A Costly and Complex System

Both supervisors and banks will need to gather and analyze a considerable amount of new data to implement the more complex models proposed by the Committee. This will be a costly process for all the parties involved. At this point, it is not at all clear that the desired benefit -- more precise estimates of operational risk exposures -- will be achieved; nor is it clear that the estimates obtained will have warranted the costs expended.

While some large banks are developing quantitative models of operational risk, and there are growing international consulting practices aimed at improving the measurement and management of operational risk, we are still in the early stages of development. Nevertheless, the Committee is proposing specific and complex measurement techniques and, in so doing, is jumping to conclusions about where best industry practice in modeling operational risk is headed. Core assumptions underlying the models proposed by the Committee have not been tested. Where they have been tested, such as the relationship between scaling variables (e.g., asset size) and operational losses, the empirical evidence contradicts the Committee's assumption, indicating a highly nonlinear (i.e., non proportional) relationship rather than a proportional one. A doubling of asset size, for example, does not appear to lead to a doubling of the operational risk exposure as the Committee assumes.

More fundamentally, the quantitative methods for measuring operational risk the Committee is proposing are not well grounded in best industry practice. A particular danger is that the regulatory models supervisors encourage banks to use will not be nearly as good as the ones that banks would have developed on their own. Because banks will have strong incentive to manage to the regulatory models, missteps by bank supervisors are likely to hold back the development of better operational risk models.

Disincentives to Transfer Risk

The success of the framework the Committee has proposed rests on giving banks lower regulatory capital requirements as an inducement to measure and monitor their operational risk more accurately and to manage it well. To work as they intend, supervisors must set the risk related coefficients correctly in order to determine appropriate regulatory capital charges. Otherwise, they could create a disincentive for banks to measure their operational risk accurately and to adopt more cost-effective risk mitigation and risk transfer solutions.

We fully recognize the figures the Committee published in the consultative package are only preliminary and will be refined. Yet, the fact that there is such wide disagreement over what the data show serves as a strong reminder of just how difficult it will be to get the coefficients right. Using data form a small sample of banks, the Committee reports that institutions allocate roughly 15 to 25% of economic capital for operational risks. Many banks, however, have publicly commented that their internal data show that economic capital allocated for operational risk amounts to no more than 10% of capital. Clearly, an overcharge for regulatory capital of this magnitude could mean that banks will choose to retain their operational risk exposure, rather than pay additional money to transfer it to a third party who would be willing to cover the risk at less cost. This will certainly follow if banks are not allowed to substitute insurance, a form of contingent capital, for regulatory capital as seems to be the case under the current proposal.

Our Suggested Approach

We believe the Committee must move considerably more in the direction of using controls and insurance to mitigate and transfer exposure to unexpected losses from operational risk. The supervisory focus on controls should be on those areas where operational catastrophes could cause the institution to fail or cause serious systemic events. Moreover, banks should be permitted to substitute insurance, which meets minimum standards set by the supervisors, for regulatory capital requirements for operational risk. As contingent capital, insurance would create a buffer against loss to the banks, similar to regulatory capital, and could give supervisors more time to react to serious operational problems before the bank becomes insolvent.

Insurance offers important enhancements to supervisory review and market discipline. First, the underwriting process can provide an independent perspective on the quality of the bank's systems and controls and on its risk profile. Typically, insurance companies require banks to undergo extensive checks (some of which are ongoing) before they are willing to issue a policy. Second, for risks that are largely exogenous to the bank (such as an Internet based attack against a service provider), insurance is likely to be a less expensive way to mitigate risk than requiring each bank to set aside capital to cover such exposures. Third, insurers would impart a measure of market discipline since the pricing of polices would reflect an independent assessment of the level of risk at each institution.

Fourth, by relying on insurance, supervisors could reduce the cost and administrative complexity of the risk based capital framework for operational risk. Competitive forces in the insurance markets would determine how much accuracy and complexity in risk measures was worthwhile.

We would be pleased to offer any assistance we can to help inform staff at your agencies or the Committee on the current state of insurance techniques to mitigate and manage operational risks.

Sincerely,

Heidi G. Miller