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Secretariat of the Basel Committee on Banking Supervision

Bank for International Settlements

CH-4002 Basel

Switzerland

3 June 2016

Response to the Basel Committee on Banking Supervision Consultative Document on the Standardised Measurement Approach for Operational Risk – Issued March 4, 2016

Ladies and Gentlemen of the BCBS,

We welcome the opportunity to respond to the Basel Committee's Consultation Document on the Standardised Measurement Approach (SMA) for operational risk.

XL Group PLC through its subsidiaries is a global insurance and reinsurance company with total assets of $58.7 Billion. We are one of the largest insurers of banks and other financial institutions in the world.

This paper contains our thoughts on the SMA and recommendations on refinements to further the Committee's objectives of Simplicity, Comparability and Risk Sensitivity.

We appreciate the Committee's commitment to the consultation process and are open to any communication or questions regarding the feedback we have provided in this response.

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Executive Summary

- Operational risk is characterised by the emergence of sudden, extreme losses, which can threaten the viability of individual banks and the financial system.
- Operational risk is a risk category encompassing a large range of discrete risks and is primarily driven by behaviours internal to each bank.
- By creating an explicit connection between sound operational risk management and regulatory capital levels, banks' senior management have been rendered accountable for actively controlling exposures and investing in effective risk management frameworks and mitigation techniques.
- In its current form, the SMA eliminates this connection, reducing the effectiveness of risk management in the business as the first line of defence and diluting the leverage of the second line of defence.
- The SMA also takes insufficient account of the potential for extreme, unexpected losses.
- Banks, and their supervisors, would benefit from the SMA:
  - Explicitly incorporating the assessment of possible extreme events in the calculation
  - Recognising the benefit of active risk management
  - Incorporating the impact of strategies designed to improve recoveries, including insurance, into capital assessments
- These refinements can be made simply, meeting the Committee's objectives for Simplicity, Comparability and Risk Sensitivity.

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Managing Operational Risk

The Committee was prescient in identifying operational risk as a distinct risk category, requiring active management by banks in the Basel II Accord. Large losses during, and subsequent to, the financial crisis have only served to highlight the importance of adequate capital and the effective management of operational risk. Since the financial crisis, operational risk has overtaken market risk in many banks, now ranking second only to credit risk as a determinant of economic and regulatory capital.

Due to two unique characteristics of operational risk, regulatory capital assessment has a unique role in the effective management of this risk category:

1. **Operational Risk is characterised by the potential for sudden, extreme events**

   From the classic example of the collapse of Barings bank to more recent events, the defining aspect of operational risk is the potential for very large losses to come "out of nowhere", potentially causing severe damage to individual firms and threatening the stability of the financial system. Unlike credit and market risks, these losses are not due to an explicit business decision to take on specific risks in the hope of generating a return. Instead, these exposures are largely a function of complex entities involving thousands of employees and a multitude of processes.

2. **Operational Risks are primarily behavioural risks, which are highly individual to each firm and constantly changing**

   Historical loss experience demonstrates that, unlike credit and market risk, major operational risk losses are primarily driven by the behaviour of each bank's employees and management and not by any market forces. [1]

   As evidenced in the range of risks identified by regulators in the Basel II Accord, operational risk is an umbrella term for a wide range of discrete risks. In addition, the nature of the operational risk profile of each bank is subject to often, sudden change as businesses, products and processes evolve as well as due to external factors such as innovations in technology.

   In terms of the potential for major losses, banks with a weak risk control frameworks will experience multiple, distinct, large loss events as well as a sequence of similar losses.

[1] Operational Risk Data Exchange Report 2015 – The two major operational risk categories by severity are Clients Products Business Practices and Execution Delivery Process Management

The Role of Capital Assessment in Operational Risk Management

The prospect of extreme losses, coupled with the highly individual nature of banks' operational risk profiles means that, to a far greater degree than for other risk categories, the operational risk capital assessment process has a dual role:

1. To ensure that banks retain sufficient capital to absorb large losses from potentially major operational risk events.

2. To provide the mechanism by which the three lines of defence work together effectively to prevent operational risk losses and to mitigate the damage caused by those which do occur. While it is difficult to predict exactly which extreme, or "spike", losses will occur, it is possible to determine the most likely manifestations of extreme events and to prepare for them. The most effective defence against major losses is the combination of active risk management allied with sufficient, risk sensitive, capital.

Essentially, regulatory capital requirements provide leverage for risk management to influence the behaviour of other parts of the organisation, particularly front line businesses.

The direct financial impact of operational risk capital requirements should be:

- Firstly, to penalise conduct detrimental to the ongoing viability of a bank.

- Secondly, to engage the attention of senior and business line management - encouraging investment in the controls and risk mitigants required to minimise losses.

It has been argued that prudent banks would implement sound measures for managing risk without regulatory imperatives. The claim is that the promise of fewer losses provides sufficient financial inducement to invest in better controls. Unfortunately, this only seems to work for expected losses where improvements in controls can be demonstrated to show an immediate impact on loss amounts. It is less effective for risks characterised by large irregular losses such as operational risk.

Well-managed banks can be counted on to invest in identifying, quantifying and actively managing infrequent but extreme risks. Nevertheless, repeated experience with rogue trading, as well as other losses, has shown that there will always be banks susceptible to over-confidence and the immediate promise of lower costs obtained through underinvestment in internal risk management. The article referenced in Footnote 2 illustrates an example of this mentality and its repercussions for a major UK bank.[2] Focusing on reducing costs and

[2] "The HBOS horror story is a grim read" Philip Aldrick. The Telegraph. 9 March 2012

achieving minimum compliance, rather than managing risk, these institutions threaten the stability of the financial system as well as their own viability. In its current form, the SMA does not differentiate banks with effective risk management frameworks from their peers, effectively penalising well managed firms.

Disconnecting capital assessment from risk management risks transforming the first and second lines of defence into paper tigers, focused on compliance rather than risk management.

Internal risk managers perform a function closely aligned with supervisors' objectives. It is in the interest of banks, supervisors and the financial system as a whole, to ensure that risk managers in the first and second lines of defence have effective means of influencing decision making by senior and business line management. The ability to affect final capital requirements is a uniquely powerful tool for focusing management attention and influencing institutional behaviour.

Evolving the SMA

The AMA, for all its limitations, has driven fundamental, large-scale, improvements in the banking industry's approach to operational risk management.

We remain firm supporters of internal modelling for operational risk. In our view the Committee's objectives of Simplicity and Comparability could also have been achieved by measures such as restricting the choice of statistical distributions used by banks for modelling "tail" events, while retaining the risk sensitivity of the AMA.

Nevertheless, we believe the Committee's objectives of Simplicity and Comparability, along with Risk Sensitivity, are worthwhile and that the SMA should be modified to maintain the following benefits initially generated by AMA implementation.

- Encouraging investment in risk controls and risk mitigation by maintaining an explicit link between capital assessment and active operational risk management, including the use of insurance.
- Active identification and management of potential extreme losses and emerging risks.

Modifying the SMA - Increasing Risk Sensitivity

The SMA should be modified to place more focus on the Risk Sensitivity component of the Committee's objectives.

Specifically:

- The Loss Component requires banks to hold capital due to past losses. Losses which have occurred in businesses a bank has completely exited no longer reflect the risk profile and current capital requirements. These losses should be removed from the Loss Component element of the assessment to the extent that the bank no longer has exposure to those risks.

- The Loss Component works to increase capital only after a major operational risk event has occurred. It is more prudent to ensure that capital requirements also reflect emerging risks. Cyber risks are an example of a type of risk that a particular bank may not have experienced yet, but which represents a major concern for the industry.

- Banks must be able to consider the impact of extreme operational risk events. The simplified scenario analysis approach described in our recommendations below represents an effective means to capture emerging risks and to estimate capital requirements for large, unexpected, losses.

Additionally, the SMA disincentivises risk management and loss mitigation by ignoring their impact on the risk profile and capital requirements. Removing the ability for risk managers within the bank to have a meaningful impact on SMA capital requirements essentially reduces their influence within the bank to an advisory role, primarily focused on compliance. Coupled with current decreasing expenditure on modelling and active risk management[3], this demotion of the role of risk management is already leading to experienced operational risk managers leaving the industry.

Our recommendations:

- There is a lack of clarity about the interaction of the SMA with Pillar II. We note guidance for Pillar II was recognised as necessary by the Committee when the revised

[3] "Banks cut budgets for maths and models as rules change." Financial Times, 23 May 2016 attached as a separate document to this response

simpler approaches were first announced in October 2014[4]. The issuance of this guidance should be fast tracked by the Committee.

- Banks' own assessment of future extreme risks should be incorporated into the SMA in the form of a simplified scenario analysis process. Unlike the AMA, the simplified scenario analysis process is not meant to be an input into a loss distribution but a simple detailed example of a potential loss with the financial impact added to the SMA calculation. The total impact of these self-assessments can be limited to a standard percentage of the total – to be determined by supervisors.

- Scenarios can be standardised through the use of a standard set of scenarios, set by supervisors, which could be derived from the US Comprehensive Capital Analysis and Review (CCAR) process or developed from the European Central Bank (ECB) stress test process.

- Additional scenarios reflective of recent industry experience, in the form of recent external events, should also be created by banks.

- In assessing the impact of these scenarios banks should be able to take into account the impact of risk management and control improvements. Conversely, banks shown to have insufficient controls and preparedness should be penalised through higher capital requirements.

- The impact of risk mitigation should also be incorporated as a net adjustment to scenario impacts – as described in the following section.

Modifying the SMA – Incorporating the Impact of Insurance

Introduction

Banks, their supervisors and insurers all derive substantial practical benefits from the use of insurance to manage operational risk.

This section discusses how the process of insuring operational risks:

- Effectively encourages banks to continually improve their operational risk management.

- Assists supervisors to oversee operational risk management within banks.

[4] BCBS291 Operational risk – Revisions to the Simpler Approaches. October 2014

- Improves decision making by insurers, leading to the evolution of more effective insurance products, while also improving the stability of the financial system.

The section concludes with some suggestions for including the impact of operational risk insurance in the SMA.

The concept of using insurance to manage operational risk exposures is not new. Banks and other industries have long recognised that insurance is an effective mitigant for major operational risks. Before the recognition of operational risk as a major risk category in the Basel II Accord, the insurance programme represented the main, formalised, approach for handling these risks for many banks.

The Committee itself has repeatedly recognised the efficacy of insurance as a mitigant for operational risk exposures:

- BCBS 128 "International Convergence of Capital Measurement and Capital Standards. A Revised Framework", June 2006. Basel II, recognised insurance as an acceptable part of operational risk capital.

- BCBS 160a "Results from the Loss Data Collection Exercise for Operational Risk" June 2009. Reported that "the median recovery rate is 75% for all losses with insurance recoveries".

- BCBS 181 "Recognising The Risk-Mitigating Impact Of Insurance In Operational Risk Modelling", October 2010. Recognised the efficacy of insurance and outlined the Committee's standards for acceptable insurance policies.

- BCBS 195 "Principles for the Sound Management of Operational Risk" June 2011. Supported the use of insurance to mitigate losses in paragraph 55 which states that "In those circumstances where internal controls do not adequately address risk and exiting the risk is not a reasonable option, management can complement controls by seeking to transfer the risk to another party such as through insurance."

The emergence of operational risk as a distinct category of regulatory capital within banks has vastly increased bank management focus on these risks, while the new risk management frameworks have generated a large amount of new, high quality, information on risk exposures. These developments have driven major improvements in the insurance solutions available to banks for mitigating their operational risks.

At present a large number of banks and other financial institutions around the world are actively using insurance as part of their operational risk management, having confidence in its performance as a mitigant for large operational risks.

The insurance industry has responded by developing new solutions, explicitly aimed at providing banks with:

- Confidence in timely claims payment in the event of a loss.
- Larger capacity to absorb even extreme losses.
  - Banks can now raise over $1 Billion, per firm, in additional insurance capital to fund potential operational risk exposures, at competitive rates.
- Customisable coverage to reflect each bank's unique risk profile
- Clarity of coverage, eliminating jargon and using each bank's own risk taxonomy to define coverage, making the products easier to understand for bank management and supervisors.
- Shorter, simpler, more transparent contracts.

The application of these new solutions was delayed in some countries as banks concentrated on refocusing their businesses and supervisors revaluated capital models in the aftermath of the financial crisis.

However, as operational risk frameworks were reapproved and have banks become more confident in the risk information they can present to insurers, there has been renewed investment by insurers in improved solutions designed to assist banks to transfer their large operational risks. An interesting outcome of the focus on operational risk by banks is that, increasingly banks are focusing their insurance cover on the large, unexpected exposures, rather than smaller, more frequent losses. This redeployment of cover to the more severe exposures has led to more effective risk management, protecting banks' customers and the financial system.

Insuring operational risks

The risk underwriting process which insurers use to assess risk and develop cover is key to how insurance delivers the benefits listed in the introduction to the previous section.

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As experienced assessors of risk, with their own funds at stake, insurers are keen to ensure that they deal with soundly managed banks with effective, comprehensive, risk management frameworks.

As well as gaining an in-depth understanding of the nature of each operational risk they are insuring, and its potential frequency / severity characteristics, insurers look for the following characteristics in the banks they insure:

- Comprehensive risk control structures in place to minimise the potential for loss.
- Effective processes and procedures for loss identification, categorisation, aggregation, reporting and escalation.
- The retention by each bank of a material portion of the exposure, to reduce the potential for moral hazard.
- A well-defined and sound risk governance framework with a proactive risk management culture. Particularly important is the ability to demonstrate that senior executives are actively involved in risk management and that their risk tolerance goals are translated into investment for risk control and mitigation.

Information flows during the underwriting process

Before insuring a significant operational risk, insurers require each bank to provide comprehensive risk assessment information, from both a historical and forward-looking perspective. Insurers benchmark this data against other banks, and financial institutions, in terms of current loss frequency and severity, as well as potential losses and emerging issues.

Insurers are keen to identify emerging risks through a thorough understanding of each bank's plans to evolve its business, including changes in product mix, the launch of new businesses or retrenchments from existing lines.

Having assessed the risk, insurers work with banks and their advisers to design the cover and to develop terms and pricing commensurate with their view of the risk. Banks perceived to have better risk management relative to their peers enjoy an advantage in terms of pricing and capacity availability. Conversely, banks with poor risk management will find themselves paying a higher risk premium and may struggle to find their desired level of insurance capacity for key risks. These factors act as an inducement for banks to invest in continually improving their risk management frameworks and not to fall behind their peers.

i. **Benefits for banks**

For banks there are two main benefits from the use of insurance to mitigate operational risk

a. **Access to a substantial pool of long term capital which is not correlated with other forms of capital**

- Insurance has proven to be a stable form of funding for operational risks. This was highlighted by the experience of the financial crisis where when other financial markets had frozen, even distressed banks were able to renew their insurance programmes. The insurance industry also came through the financial crisis in far better financial shape than the banks, requiring only approximately 10% of the additional capital (mostly for a few insurers with wholesale banking operations) and maintaining stability of pricing and capacity availability.[5]

- Banks can access multiyear policies to cover operational risks. These policies can be non-cancellable by the insurer, providing confidence in the long-term nature of the contracts.

- Unlike other forms of financial contracts, insurance policies can continue to provide cover after they have expired. If a bank discovers a covered loss occurring in a prior year many policies will pay for that loss, even though the policy itself may have expired and been replaced with a current policy.

- Proof of compliance with the "use test". Insurance represents an effective way for bank boards to ensure that they are keeping their exposure to risk within their defined risk appetite.

b. **Information on Operational Risk exposures and management practices**

By virtue of the insurance industry's exposure to operational risks across many firms and geographies, the operational risk insurance process provides banks with access to valuable information on risk exposures, current risk pricing and industry standard operational risk management practices.

[5] "Systemic Risk in Insurance – An analysis of insurance and financial stability" – Geneva Association Systemic Risk Working Group. March 2010

Information from brokers

Even before approaching insurers, banks have access to substantial information provided by their brokers and other advisers. Typically this information includes benchmarking each bank's risks against their local and international peers, and the experience of their industry sector. Risk mapping projects by brokers also provide information on the effectiveness of current programmes against each bank's risk profile and recommendations for coverage alternatives and improvements.

Information from insurers

As well as employing their own expertise, insurers are in a position to review operational risk profiles and risk management practices at many banks around the world. This experience allows them to identify trends and develop an authoritative view of major emerging risks and industry best risk management practice. Cyber risk represents an example where insurers are helping to disseminate information on best risk management practices.

This experience enhances banks' own work in risk identification and control, as well as loss minimisation and mitigation, serving as a valuable support to internal risk management and supervisors' review. Consequently, the risk underwriting process can provide banks with valuable feedback and guidance enhancing their ability to:

- Understand, anticipate and mitigate extreme or "tail" operational risk exposures.
- Optimise risk control and mitigation.
- Access analysis of their risk profile and how it compares with peers.

ii. Benefits for supervisors

Insurers, as independent assessors of bank operational risk exposures and risk management frameworks, share the following objectives with supervisors:

- Long term stability within the banking industry and for individual banks.
- The application by banks of sound risk management cultures and practices, supported by effective risk control frameworks.

As described above, the insurance process performs a valuable role in encouraging banks to adopt effective operational risk management practices. Insurance premiums reflect the risk associated with a bank, producing an incentive to save costs by reducing the risk. As the price of insurance rises, banks face increased incentives to improve risk management and/or modify their behaviour, resulting in beneficial effects for each bank and the financial system as a whole.

Additionally, supervisors can also benefit from other information emerging via the insurance underwriting process from the following three sources:

1. Guided by the risk mapping process outlined in the 2010 Committee paper on insurance as an operational risk mitigant[6] banks conduct extensive analysis of their risks and the effectiveness of the current insurance programme and prospective coverages. This process commonly involves independent validation by a third party, usually lawyers, consultants or brokers and can be accessed by supervisors when assessing the impact of insurance on banks' operational risk exposures.

2. The submissions by banks looking for operational risk insurance to their insurers represent an excellent source of information on each bank's operational risk profile and the measures taken to control and mitigate these risks.

3. Insurance premiums effectively represent a price signal for operational risk exposures. Supervisors can use the pricing difference between banks as a proxy for the market view of each bank's operational risk exposures and the effectiveness of its risk management. Similarly, pricing trends over time can give an early indication of improvements or deterioration of the market view on a particular bank.

iii. Benefits for insurers

Insurers have also benefited from the emergence of operational risk management within banks as a specific, structured discipline.

The implementation of Basel II and the development of banks' operational risk management frameworks has led to a tremendous increase in both the quality and quantity of information available to insurers.

Access to this new information has generated the following benefits for insurers:

- It assists insurers to differentiate well-managed banks from the others, even on existing products. The outcome of this process is that insurers are in a far better position to make better decisions on particular risks and banks, leading to fewer unexpected losses and greater stability over time.

[6] BCBS 181 "Recognising The Risk-Mitigating Impact Of Insurance In Operational Risk Modelling" in October 2010

- The more transparent, granular, information being generated by banks allows insurers to adopt a more risk specific approach to selecting which risks they wish to insure. This allows insurers to build more diversified risk portfolios, reducing exposure to systemic risks.

Another benefit from the formalisation of the operational risk discipline is the focus on this often neglected risk category by bank management. This increases the likelihood that resources will be made available to manage these risks effectively leading to fewer, less severe losses over time.

As outlined in the introduction to this section, these benefits have been reflected back to the banks in the form of more responsive products and greater capacity for their major risks.

Options for including insurance in operational risk capital assessments

The previous section outlines how insurance helps to ensure that banks are stable and resilient, performing better in the long term. Integrating insurance into the SMA can be achieved in a simple, standardised manner.

There are three main methods for incorporating insurance in the SMA calculations.

i. Including insurance recoveries in the historical loss component.

ii. Including insurance recoveries as part of banks' and supervisors' own assessment of anticipated operational risk exposures.

iii. Incorporating the impact of insurance assessed in Pillar II calculations in SMA capital assessments.

i. Insurance in the historical loss component

In the historical loss component of the calculation, the capital requirement of this component should be net of insurance recoveries. Given that the premise of this calculation is that past losses are an indication of future losses, banks should be able to capture benefit for improving their insurance programmes.

However, banks should not be penalised for investing in improved insurance policies by having to wait for a paid loss before taking into account the impact of purchasing improved policies or filling gaps in coverage.

If a bank can demonstrate that any loss occurring in the past would have been covered by a policy they have since put in place, that loss should be removed from the calculation, as the bank has put in place measures to prevent suffering similar losses, provided that the bank continues to have the policy in place. The process should be based on the Risk Mapping analysis identified by the Committee in 2010.[7]

ii. Insurance as part of banks' own risk assessments

As mentioned previously, we are concerned that the SMA is focused on the smaller, expected loss section of banks' risk profile. We firmly believe that capital calculation for operational risk should also capture emerging risks and the potential for extreme losses.

As described in the section on "Modifying the SMA to Increase Risk Sensitivity" a simplified, standardised scenario process provides a straightforward, transparent and standardised method for capturing the impact of emerging risks and potential extreme events in the SMA.

Key features of the simplified scenario analysis process:

- Unlike the AMA, the simplified scenario analysis process is not meant to produce an input for a statistical model. Instead it involves assessing the circumstances of potential major losses with the financial impact added to the SMA calculation. The total impact of these self-assessments can be limited to a standard percentage of the total – to be determined by supervisors.
- Scenarios can be standardised through the use of a standard set of scenarios, set by supervisors. These scenarios could be derived from the US CCAR process or developed from the ECB stress test process.
- Additional scenarios reflective of recent industry experience, in the form of recent external events, should also be created by banks.
- In assessing the impact of these scenarios banks should be able to take into account the impact of active risk management and risk mitigation through.

iii. Incorporating the impact of insurance assessed in Pillar II calculations in the SMA assessment.

A third approach for capturing the impact of insurance in a standardised, simple way is to translate a portion of the insurance benefit assessed under Pillar II into the SMA calculation by way of a beta factor. This factor can be set at a level determined by regulators although it must still be reasonable. This is primarily important for banks whose Pillar I levels are expected to

[7] BCBS 181 "Recognising The Risk-Mitigating Impact Of Insurance In Operational Risk Modelling" in October 2010

exceed Pillar II assessments. It also allows regulators to mandate a standardised level as the maximum benefit for insurance allowable under the SMA while leveraging existing analysis undertaken for the Internal Capital Adequacy Assessment Process (ICAAP) process.

Standardised Insurance Contracts

As a general rule we do not support the concept of insurance contracts with standardised coverage clauses. As discussed in the earlier part of this paper operational risks are highly specific to each institution. As with any other form of risk control each institution achieved the most effective management of exposure by putting in place the insurance risk mitigation programme that is most closely attuned to their specific risk profile.

Conclusion

In summary, we support the Committee's, objectives in ensuring banks' operational risk regulatory capital assessments are Simple, Comparable and Risk Sensitive.

- The SMA should be modified to explicitly incorporate emerging risks and extreme losses.
- Capital assessments should also include the impact of active risk management and risk mitigation via insurance.
- These changes can be incorporated into the SMA in a transparent, straightforward way and will result in more stable banks and a more resilient financial system benefiting supervisors, banks and their customers.

Thank you for your consideration,

Yours sincerely,

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