Response to the Basel Committee on Banking Supervision
Operational Risk Consultative Document dated January 2001

Submitted by

The Property & Casualty Insurance Industry Working Group

May 25th, 2001
Executive Summary

I. This paper addresses Pillar I issues.

II. Financial institutions currently utilize a broad spectrum of insurance solutions to actively manage identified operational exposures. Properly structured and soundly underwritten products provided by financially sound insurers should receive credit against the proposed New Capital Accord calculation for operational risks. The quantitative impact of the operational risk capital calculation should be reduced by the recognition of risk transfer and risk finance insurance products. Under the proposed definition of operational risk virtually all current insurance products warrant recognition and should receive credit against the proposed New Capital Accord calculation.

III. Questions relating to insurance products will be addressed. The insurance underwriting risk assessment process provides a ground up external review of the highly evolved risk management cultures and the internal controls procedures at banks. The underwriting process is risk-sensitive and reinforces Pillar III market discipline. This qualitative and quantitative approach reflects the differing risk profiles across banks and permits insurers to craft customized risk transfer and risk finance solutions that address many of the perceived limitations in standard insurance products.

IV. The insurance industry will form technical working groups to consider and make recommendations on the quantitative, definitional, loss data, capital charge calculation and performance issues relating to risk transfer and risk finance products.

V. The insurance industry recognises that greater transparency of historical ground up industry wide operational risk loss data will be required.
1. Introduction

This document is an insurance industry response to the Consultative Document on Operational Risks Supporting Document to the New Basel Capital Accord, dated January, 2001 produced by the Risk Management Group of the Basel Committee. This paper is a voluntary effort from globally orientated property & casualty insurers and reinsurers¹ and reflects the consensus view of the signatory companies.

We submit this document for open review by all interested parties in an attempt to advance the discussion between regulators, banks and insurers regarding operational risk with a view to affirming the use of insurance products to mitigate operational risk, particularly the risk of low frequency, high severity losses.

2. The property/casualty insurance industry is a suitable counterparty for operational risk transfer

The top 38 “AA” rated or better global Property/Casualty insurers and reinsurers represent over $327 billion in adjusted capital². Overall we believe that the industry meets six important criteria to reduce the systemic risk for banks:

a) significant capital base;
b) deep operational risk underwriting expertise;
c) high credit/claims paying ratings;
d) large number of participants with high ratings;
e) historical experience in syndicating risk and managing exposure;
f) experienced in underwriting risks that are inherently difficult to quantify.

3. Guiding principles

The insurance industry has significant expertise and experience in the identification, assessment and transfer of operational risks. We strongly advocate that both current and future risk transfer and risk finance insurance products have a meaningful role to play in the determination of net capital requirements.

3.1 Current insurance products provide substantial transfer of operational risks

Insurance solutions have always dealt with unexpected losses from operational risks. There are a substantial number of existing policies that address specific classifications of operational risk. These policies include All-Risk Property, General Liability, Bankers Blanket Bond (Employee Dishonesty), Directors & Officers, Professional Indemnity (Errors & Omissions) and Employment Practices Liability. Institutions demonstrating a proven risk management and control structure are able to obtain superior insurance terms than institutions with weak risk management and control structures in place, thus rewarding good practice.

¹ See Appendix I: Individuals who contributed to this paper.
² See Appendix II: Top 38 Global P&C insurers and reinsurers including surplus, rating and leverage.
Questions relating to insurance products can be addressed

The Consultative Document raises questions in Section X., Subsection 50. “Risk Transfer and Mitigation”, relating to the performance and robustness of insurance contracts. We recognize that increased dialogue is needed between regulators, banks and the insurance industry to understand these concerns and to respond accordingly.

Insurance industry working groups will be formed to develop a methodology whereby the robustness of insurance and risk transfer products can be assessed in the context of the concerns expressed. This analysis will serve to identify the efficacy of current insurance products. Where necessary the insurance market has proved responsive to buyer needs.

The insurance industry is actively developing new risk sensitive operational risk transfer and risk finance products

The insurance industry has a proven track record of innovation. This deep underwriting expertise and industry focus positions insurers to creatively respond with risk transfer solutions to the evolving risk management and regulatory landscape for financial institutions. There are numerous examples of rapid industry response to emerging risk exposures. Recent examples include employment practices liability products, unauthorized (rogue) trading products, representations and warranties liability products, tax-liability products and broad form organizational (management) liability products. Most recently insurers are responding to the emerging risks of electronic commerce with a variety of first and third party e-commerce liability products.

As a universally accepted methodology to define, identify and measure operational risks evolves this will permit the creation of insurance product standards. These standards or common components will specifically address the minimum criteria in the areas of voidability, settlement and counterparty risk. This approach will maximize the entrepreneurial and creative power of the property & casualty insurers to work together with financial institutions to craft specifically tailored risk sensitive insurance solutions. It will also encourage the very competition and qualitative differentiation of insureds that are important characteristics of a healthy market.

Requirements for the integration of insurance products into the new capital accord on operational risks.

There are some areas requiring development that would precede a robust market in enhanced operational risk insurance products meeting the diverse needs of banks, regulators and the

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3 There are many examples where individual insurers, have responded, to buyer concerns of a similar nature. For example:

**Liquidity and Loss Adjustment**
- Insurers have already addressed questions with regard to the timeliness and certainty of claims settlement. For example, pre-agreed fast track mechanisms for claims settlement have been introduced in some current policies. Both counter-parties enter into express performance commitments. This provides the certainty that claims settlement will occur in the same earnings period as the loss.
- Bilateral, industry-wide, alternative dispute resolution mechanisms can be widely applied.

**Voidability and Cancellations**
- Voidability of contracts are limited to mutually pre-agreed conditions or the non-payment of premium.
- Most current insurance contracts provided to institutions demonstrating a well-developed risk management control structure are irrevocable (non-cancelable) and have negotiated multi-year policy periods.

**Contracts should be renewable or have pre-negotiated reinstatements pre-loss or post-loss event**
- Multi-year commitments are available from numerous insurers. Both pre and post-loss reinstatement agreements are commonplace.
providers of capital (insurers). These developmental needs would be best satisfied by a close
working relationship between the property and casualty insurance industry and financial
institutions that would parallel the proposed New Capital Accord.

In order of precedence, we believe the minimum requirements for the successful integration of
insurance products into the capital requirements for operational risk are:

4.1 **Bilateral agreement on standard, positive definitions of operational risk that are discrete
and measurable.**

We endorse the proposed definition of operational risk which includes legal risk but
excludes liquidity, market, and credit risk:

"Operational Risk is the risk of loss resulting from inadequate or failed internal
processes, people and systems or from external events."

Defined operational risks should be **positive, specific, discrete, measurable** and
**quantifiable**. A definition of operational risk universally recognized by regulators, banks
and insurers is fundamental to the quantification of operational risk. A quantifiable
definition of operational risk is a prerequisite to a transparent, robust and efficient risk
transfer market that uses insurance products to mitigate operational risks. Under the
proposed definition of operational risk virtually all current insurance products warrant
recognition and should receive credit against the proposed New Capital Accord
calculation.

4.2 **Bilateral agreement on the (CaR) measurement methodology**

A consistent, systematic methodology for identifying and quantifying causes of loss, loss
events and loss impacts that is subject to regular and independent verification in order to
prove the integrity and relevance of the operational risk data set;

In the evolutionary process many institutions will ultimately have the ability to calculate
their regulatory capital requirement for operational risk on a regular, independent and
current basis. We recommend that the methodology used by banks, regulators and
insurers to calculate the quantitative impact of capital requirements be compatible. We
further recommend that insurance products be included in the quantitative impact
computation of regulatory capital requirements for operational risk. The computation of
the quantitative impact of the new capital requirement should be transparent and
independently verifiable.

4.3 **Creation of pooled operational risk data bases and bilateral sharing of operational risk
data**

Codified and centralized operational risk databases using consistent definitions of loss
types, risk categories and business lines are necessary to facilitate both the Internal
Measurement Approach and the efficient risk transfer of operational risks to insurers.

The property and casualty insurance industry has extensive, historical, ground up industry
wide operational risk loss data distributions and is prepared to share this data to further
refine the calibration of the net capital requirement for banks.
4.4  **Mapping of event (peril) and effect (loss) by business type, to business line and indicator**

We recommend bilateral industry agreement on operational risk definitions, categories of operational risk by business type, line of business and indicator. The property and casualty insurance industry is prepared to map identifiable hazards, perils and loss and categories of operational risk by business lines and risk types.

5.  **Property & casualty industry technical working groups on operational risk**

A number of technical working groups will be immediately established to resolve the issues presented in this document. These technical working groups will work with banks and regulators to achieve tripartite agreement, within the timeframe laid down by the Basel Committee on:

a) Definition of operational risk(s) and mapping of cause of loss to operational risk loss events and loss impacts;

b) The quantitative impact of insurance products and its application to each of the three stages of approach defined in the New Basel Capital Accord;

c) Data collection transparency, data access and data pooling;

d) Claims settlement and dispute resolution proposals;

e) Performance of current insurance products in relation to actual operational losses and mapping of the probable effect of new products on operational risk capital charges;

f) The capital charge methodology.³

6.  **Recommendations**

I. Properly structured and soundly underwritten insurance provided by financially sound insurers should receive credit against the proposed New Capital Accord calculation for operational risks within Pillar 1. The quantitative impact of the operational risk capital calculation should be reduced by the recognition of both currently available risk transfer and newly designed risk transfer/risk finance insurance products;

II. Data collection and sharing will be a critical component for both calculating the operational risk capital charge and expanding the insurance market coverage of operational risk. The insurance industry is prepared to work with banks to create/enhance existing mechanisms for collecting and sharing data on a bilateral basis;

III. Technical groups will be established to work with banks to clarify common loss definitions, methodologies, data pooling, claims settlement mechanisms and determine the precise methodology to calculate capital relief.

The Property & Casualty Industry Working Group on Operational Risk believes that the concepts discussed above will affirm the use of insurance products to mitigate capital erosion by operational risk losses and this should be reflected in the New Capital Accord. We believe that the availability of such capital relief combined with a rigorous underwriting process

³ See separate paper produced by the Basel Accord Insurance Working Group (BAIWG)
provides a strong incentive for financial institutions to improve internal controls, improve risk management, and make operational risk management more transparent. The underwriting process will reinforce Pillar III market discipline and will reduce systemic risk across the banking industry segment.

We appreciate the consideration of the Committee on the comments and proposal contained herein and solicit your comments.

Respectfully Submitted,
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Appendix I

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Appendix II

Top 38 Global Property And Casualty Insurers Including Surplus, Rating And Leverage
### Major Worldwide Property/Casualty (Non-Life) Insurance & Reinsurance Groups Rated AA- or Better - Assessment of Capacity

<table>
<thead>
<tr>
<th>Group</th>
<th>Source</th>
<th>Premium Net Written (USD '000)</th>
<th>Adjusted Surplus to Premium Ratio (%)</th>
<th>Rating</th>
<th>Lead Insurer</th>
<th>Notes</th>
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<tbody>
<tr>
<td>Bermudian</td>
<td></td>
<td>$2,454,321</td>
<td>111</td>
<td>AA</td>
<td>Best's</td>
<td></td>
</tr>
<tr>
<td>Chubb Europe (Data not included above in Chubb US)</td>
<td></td>
<td>$425,020</td>
<td>0.9</td>
<td>AA</td>
<td>Best's</td>
<td></td>
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<tr>
<td>Chubb Europe</td>
<td></td>
<td>$2,134,340</td>
<td>1.00</td>
<td>AA</td>
<td>Best's</td>
<td></td>
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<tr>
<td>Hartford Insurance Group</td>
<td></td>
<td>$1,386,673</td>
<td>0.30</td>
<td>AA</td>
<td>Best's</td>
<td></td>
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<tr>
<td>Levinyl Mutual</td>
<td></td>
<td>$457,816</td>
<td>0.30</td>
<td>AA</td>
<td>Best's</td>
<td></td>
</tr>
<tr>
<td>Liberty Mutual</td>
<td></td>
<td>$457,816</td>
<td>0.30</td>
<td>AA</td>
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</tr>
<tr>
<td>Lloyd's</td>
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<td>0.30</td>
<td>AA</td>
<td>Best's</td>
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<tr>
<td>Zurich Financial Services Group</td>
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<td>$5,221,000</td>
<td>0.11</td>
<td>AA</td>
<td>Best's</td>
<td></td>
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<tr>
<td>Zurich Financial Services Group</td>
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<td>$3,424,297</td>
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</tbody>
</table>

Note: Adjusted surplus includes statutory and unearned gains.