AON

Professional Risks

8 Devonshire Square
London EC2M 4PL
tel: 020 7623 5500
fax: 020 7621 1511

Mr. Jaime Caruana
Chairman of the Basel Committee on Banking Supervision
Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002
Basel
Switzerland.

25th July 2003

Dear Mr Caruana,

Aon Professional Risks appreciate the opportunity to offer our comments on the third consultative package (CP3) on the proposed new Capital Accord. Our qualifications to do so are based on the fact that Aon are one of the world's leading risk and insurance services firm and world's leading insurance broker to major financial institutions. Our comments here concentrate on the proposed regulatory capital charge for operational risk and in particular the criteria concerning mitigation of the operational risk capital charge.

The use of insurance as a risk sensitive capital mitigant under the Advanced Measurement Approach is welcomed. However, the presence of a constraint limiting recognition to 20% of the operational risk capital charge without the possibility of a review is inappropriate. We believe that by setting as such a low and permanent ceiling innovation will be stifled. Neither do we believe it is consistent with the Committee's own conclusion that it is possible to develop a flexible and comprehensive approach to operational risk, for example, through economic capital modelling. Recognition of insurance within many economic capital models is subject to the application of haircuts and other discounts. Furthermore, under Principle 2 of the Second Pillar - Supervisory Review Process - supervisors are encouraged to review and evaluate a banks capital adequacy assessments and to take appropriate supervisory action if they are not satisfied with the results. In other words, when regulatory authorities review and evaluate a banks capital adequacy and are unsatisfied, then appropriate regulatory action, for example, a supplementary capital requirement may be levied under Pillar 2.

Turning to the specific details of the eligibility criteria themselves. We note that with the exception of the sixth bullet point in paragraph 638, the qualifying criteria refer to a financial institution purchasing insurance from a third party. Unless otherwise specified, our comments also relate to a financial institution purchasing insurance from a third party.

A well reasoned approach to operational risk management would take into account the financial strength of the external insurance provider. The current proposals suggest a minimum financial strength, based on the "claims paying ability", of grade “A” or better. We agree with this approach and of the use of an investment grade or better. However, it is assumed that this grading is in place at the time of purchase. As external ratings may vary, for whatever reason, over the lifetime of the insurance contract and it is not clear how such fluctuations would be factored into the capital mitigation framework on an on-going basis. We would welcome the opportunity to work with the Committee to elaborate upon this further.

We believe a minimum contractual duration of 12 months, as stipulated in the consultation period, is pragmatic and reflects current market practice. We are aware of the mis-match between the timing of insurance coverage and the calculation of capital estimates. However, we believe that addressing this issue on a pro-rata basis is the most sensible solution. We acknowledge the Committee’s concern about the residual value of the insurance contract. However, a risk sensitive and practical approach would be to consider limit of indemnity, or more precisely the residual limit of indemnity, within the policy. For example, an insurance contract is purchased for a fixed 12 month period and this policy has a fixed limit of indemnity of $100 million against a specific event. For reasons of simplicity, the value of the deductible is set at zero and no additional limit of indemnity may be purchased. Let’s assume the defined event occurs and a claim of say, $50 million is made against this policy. At this point the residual limit of indemnity of the contract would be $50 million. The inherent value of a contract with a limit of indemnity of $50 million is less than an identical contract with a limit of indemnity of $100 million. An alternative position would be if the claim made was for $100 million (i.e. the value of the limit of indemnity). In this case, the residual value would be zero but, more importantly the limit of indemnity has been exhausted. Typically insurance contracts would terminate once the limit of indemnity has been exhausted. This then gives rise to a number of other questions relating to the Committee’s proposal to value an insurance contract through the residual maturity clause. This is another area where we would welcome the opportunity to work with the Committee.

We agree with the proposals concerning the cancellation of an insurance contract, and would suggest an arbitrary period of 90 days. With respect to renewals, we would like to note issues of concern. Firstly, a tacit renewal process operates in some, but not all, jurisdictions. If this issue is not addressed, the Committee may well be creating arbitrage opportunities as some banks will receive a more favourable treatment in some jurisdictions than others. Secondly, a potential mis-match of insurance coverage may occur when insurance policies are renewed, particularly when the bank changes insurance provider. We would welcome the opportunity to work with the Committee to clarify these positions.

The current industry position relating to insurance policies having "no exclusions or limitations based upon regulatory action or for the Receiver or Liquidator of a failed bank" is to include such exclusions and limitations. These standard clauses stipulate the insurance contract will be terminated upon appointment of a Liquidator, Receiver or Administrator, likewise, similar clauses are also incorporated which relate to the assured ceasing to be authorized to conduct business within the regulated environment. Current insurance policies do insure claims brought by regulators where such regulatory actions are for the recovery of compensatory damages owed to third parties (eg clients/customers) as a result of a wrongdoing. However we would like to bring to your attention the potential moral hazard which may arise from the use of insurance to pay regulatory fines and associated legal costs which are not considered the subject for insurance coverage.

We acknowledge that the uncertainty of payment is a concern to the Committee. Aon has recently developed a loss database (OpBase) which contains information pertaining to this. By way of example, the date the event was discovered, date the insurer was notified and the date the claim was resolved would all be caught. In addition, if the claim was subject to litigation these dates would also be captured. We would welcome the opportunity to work with the Committee on this issue.

It is recognised, the comments made so far relate to financial institution purchasing insurance through a third party. We are cognizant of the risk management implications of self-insurance through the use of captive insurers. As one of the leading companies on captives, we would welcome the opportunity to develop work with the Committee on developing robust and reliable risk sensitive solutions to the treatment of captives.

We would be pleased to offer any assistance we can to help your efforts on the further development of risk sensitive techniques for the mitigation and management of operational risks.

Sincerely,

Dr Victor Dowd

CC: Mr Roger Cole, Chairman of Risk Management Group & Washington Federal Reserve
Mr Oliver Page, UK Financial Services Authority