Dear Sir/Madam

Subject: Response to the Consultative Document for Standardised Measurement Approach for operational risk

Willis Towers Watson serves 80% of the World’s largest banks as measured by Tier 1 capital. As a leader in the insurance industry, we help our banking clients to manage and reduce their exposure to operational risk through the placement of insurance contracts, risk financing solutions and the application of valid quantitative and qualitative analysis, data and expert judgement.

In response to the BCBS consultation paper that proposes the adoption of a Standardised Measurement Approach (SMA) to operational risk, we recommend that insurance may be used as an ex-post adjustment to the SMA formula.

We recognise the drivers of simplicity and comparability in the SMA proposition, and believe the inclusion of insurance within the SMA formula will support this and provide consistency and transparency. We also believe use of insurance to mitigate operational risk contributes to the stability and resilience of the banking sector through diversification of risk to the insurance sector.

Our recommendation to allow the incorporation of insurance within the SMA calculation is based on the following principles:

1. Risk financing / insurance is widely used in the banking sector to mitigate operational risk. Insurance policies that are aligned to the operational, credit and market risk profile of a bank are a valuable and valid mechanism for transferring risk. Good risk management is encouraged by insurance companies that underwrite banking risks; and banks are motivated to improve risk management in order to reduce risk exposure and corresponding premiums.

2. Mapping of insurance to operational risk provides the basis for quantifying the value of insurance. This approach is adopted by those AMA banks that incorporate the impact of insurance within capital modelling. This accounting of insurance in determining capital requirements not only allows for third parties (insurance companies) to review banks’ approaches to risk management, it also motivates banks to diversify risk from the banking sector.

3. Removing the ability of banks to determine capital requirements risks reducing the influence and leverage of the second line of defence. Sound risk management is built on the fundamental principle of three lines of defence; currently the second line of defence is able to influence capital determination through incorporation of risk transfer within capital modelling. Removing the ability to factor insurance into the SMA formula risks reducing the influence of the second line, thereby compromising governance of risk management.
4. Insurance policies are transparent, easily comparable, simple, well-understood and have a proven track record of mitigating risk. We propose that insurance can be accounted for in applying loss history to the SMA calculation, and the ability to factor insurance in determining capital requirements also continues with the application of haircuts to account for credit risk (insurer default), contract certainty and timeliness of payment. To promote transparency and support comparability we recommend that firms disclose their analysis of the extent to which insurance acts as mitigant to their operational risk exposure.

Willis Towers Watson believes there are three distinct approaches to utilising insurance in mitigating operational risk; all of which we propose are continued under the SMA.

a) Traditional insurance placement: policies that are aligned to a bank’s risk appetite and profile is a valuable mechanism of risk transfer that is undertaken across the banking sector.

b) Innovative risk transfer solutions such as insurance policies that protect a bank for specific operational risks over the course of a number of years.

c) Risk transfer contracts that cover a basket of operational risks at a very high attachment point (high risk retention for the banks) that may be structured to ensure expeditious claims payment thereby maintaining liquidity in the event of a loss.

Each of the three applications of insurance outlined above are valid methods of diversifying risk away from the banking sector. Through considered structuring and contract wording that is aligned to a bank’s risk appetite and risk profile, we contend that insurance motivates banks to implement sound risk management, and is a liquid source of capital.

We look forward to engaging further with you in respect of this issue, and would be pleased to provide further materials and data in support of this approach.

Yours faithfully,

[Signature]

Dominic Casserley