AMERICAN ACADEMY *of* ACTUARIES

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Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel, Switzerland
Via email: baselcommittee@bis.org

The American Academy of Actuaries[1] ERM Subcommittee is pleased to provide its comments on the Basel Committee on Banking Supervision's consultation document, *Recognizing the risk-mitigating impact of insurance in operational risk modelling*.

1. Executive Summary, page 1, paragraph 1: The paper "raises a number of key considerations and complexities in the recognition of insurance mitigation in Advanced Measurement Approaches (AMAs), including concerns surrounding the quantification of a capital reduction for insurance." The paper also addresses the extent to which other risks are created as a result of insurance risk transfer. The modeling challenges discussed within this paper are consistent with those addressed by insurers when recognizing the impact of reinsurance on economic capital. Most advanced economic capital models are designed to reflect the key features of an insurer's reinsurance policies, including both the loss limiting features as well as the uncertainties as to the timing and amount of reinsurance recoveries. Regardless of the structure of the reinsurance policies themselves, the use of reinsurance creates the need for credit risk capital associated with these contracts as long as risk is transferred.

2. Section 1, The Basel II Framework, page 2, paragraph 2: We agree with the statement that "insurance must be recognized as a risk mitigant, and not as a substitute for capital." An insurance policy must transfer risk to be considered to offer a viable offset to operational risk capital, and therefore the insurance policy itself must be designed to maintain a reasonable degree of uncertainty as to the timing and amount of claims payments. Supervisors should require banks who request the use of insurance as an operational risk mitigant to produce evidence that the insurance contracts relied upon do in fact transfer risk.

3. Section 1, The Basel II Framework, page 3, bullet 1: To the extent that Basel changes the requirement that insurer's rated "A (or equivalent)" are the sole source for the insurance policies that could be relied upon to mitigate a bank's operational risk capital, then the credit risk charge (or "haircut" to the capital reduction) may need to change accordingly. We do recommend that banks perform their own insurance credit risk analysis to

[1] The American Academy of Actuaries ("Academy") is a 16,000-member professional association whose mission is to serve the public on behalf of the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

determine the credit risk "haircut" applied to the insurance offset, rather than placing sole reliance upon financial strength ratings from rating agencies, whenever possible.

4. Section 2, Background and Objective, page 4, question (v): The recognition of insurance mitigation would only be prudent if a bank's insurance contracts truly transfer risk, the bank's operational risk models are sophisticated enough to simulate operational losses that can be directly mapped to specific insurance policies, and the response of those insurance policies to operational losses are well understood by the bank and properly reflected in the operational risk models.

5. Section 3, Insurance Industry Supervision, page 5, paragraph 2: We would agree with the concept of insurance and banking regulators sharing the capital requirements associated with the transfer of risk from the banking sector to the insurance sector. Regulators should not, however, expect that the reduction to a single bank's capital requirement should necessarily be offset by an increase in its insurer's required capital. As a result of the effects of pooling of risk and other diversifications, the insurer might be able to take on the risk without as large an increase in required capital. It would be helpful to insurance regulators to understand SIGOR's industry estimate for the potential size of this risk transfer.

6. Section 4.3, Approval of Insurance Contracts, page 7, paragraph 1: Consideration should be given to the probability, timing, and the *amount* of insurance claims payments in the context of modeled operational losses.

7. Section 5, Maximum 20% Operational Risk Capital Charge Reduction, page 8, paragraph 3: Given that the 20% is meant to be a cap and that the average is likely significantly below this level, we would suggest that there possibly be a more rigorous demonstration of the credit for any reduction in excess of some level, possibly 15%. We agree that models reflecting insurance portfolios designed to achieve any capital reduction need to be subject to "appropriate challenge, validation and sensitivity analysis" by an actuary or other qualified insurance expert. We also recommend that banks utilizing these portfolios be able to clearly demonstrate that the underlying insurance policies do transfer risk outside the group (as discussed in Section 8.6), and that the operational risk models supporting any reduction to operational risk capital are sufficiently transparent and robust.

8. Section 7, Traditional and Proposed Insurance Policies, page 9, paragraph 3: We believe that banks should be required to demonstrate clear, modeled insurance policy response to modeled operational losses, independent of whether the insurance policies have been traditionally offered in the marketplace or are being developed to respond to a basket of operational risks. We agree with the cautions identified in this paragraph.

9. Section 8.2.1 Renewable and equivalent cover: We strongly agree that in tail situations, coverage might greatly increase in cost or, in extreme situations, not be available. This should be reflected in any capital model along with the probability that an insurer might not be able to make good on all of its obligations due to its own financial challenges.

10. Section 8.3 "…minimum notice period for cancellation of 90 days": We would suggest that the "more expansive interpretation" of applying to both parties be a recommendation. As it is currently worded, it still allows it to be applied to just the insurance company.

11. Section 8.5, "The risk mitigation calculations…," page 14, paragraph 1: We agree that supervisors "should require banks to map their insurance policies to the Basel II event types and/or the banks' own loss categories as a prerequisite for applying to recognize insurance mitigation."
12. Section 8.8, "The bank discloses a description…," page 15, paragraph 1: We agree that the requirement of additional disclosures about the "use of insurance for the purpose of mitigating operational risk" would be beneficial to supervisors. The disclosures should at least include descriptions of the forms of insurance being employed, how the insurance serves as a risk mitigant and the impact of this risk mitigation.

Thank you for this opportunity to comment. If you have any questions, please contact Tina Getachew, Senior Risk Management and Financial Reporting Policy Analyst, via email (getachew@actuary.org) or phone (202/223-8196).

Sincerely,

Maryellen Coggins
Chairperson, ERM Subcommittee
Risk Management & Financial Reporting Council
American Academy of Actuaries