# INSURANCE OF BANKING OPERATIONAL RISK

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*The current financial crisis is not a singular event in the history of crisis episodes. The essential difference between past episodes of financial turmoil and the actual crisis is the unprecedented severity, the pace of contagion and its global size. Financial markets have been seriously disturbed, threatening the robustness of financial institutions and their ability to meet current needs to properly manage the risk. One such risk is operational risk, which has become an important source of loss for credit institutions. In this context, the main purpose of this study is to present the best techniques and methods of managing this risk, less addressed problem in the literature from our country.*

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## 1. Insurnce as means of protection against operational risk

The Basel Agreement on required minimal capital acknowledges the role insurance can play in diminishing the financial impact of the operational losses of a bank. In a more and more competitive environment, as that of the bank industry, the transfer of risk to an insurer can contribute to the bettering of performance indicators and of cash flows, preventing crisis situations. Moreover, the insurance proper can be accompanied by connected services of risk management, which would allow a bank to more properly define its own risk profile.

In the consulting document on operational risk, promoted by the Basel Committee in 2001, it is acknowledged that insurance can be seen as a tool of diminishing the financial impact of operational risks of banks. In the acceptation of this document, the diminishing of the financial impact refers to the fact that concluding a specific insurance against operational risks can lead to a lower level of necessary minimal capital allocated to this risk category.

Still, it is pointed out that the market of insurance against operational risks itself passes through a stage in its development and maturation, so that banks can find themselves in the situation of replacing the operational risk by a counterparty risk.

## 2. Products of insurance against operational risks

Although they occur in a standardized form, these policies undergo several adaptations - depending on the demands of the insured customer – in that some clauses get eliminated and several supplementary ones are introduced, all with specific reflection in the price level.

- *Employment Practices Liability* (employer's liability) - covers compensation to be paid by the insured because of violation of labour law (discrimination, breach of employment contract etc.).
- *Non-Financial Property* - covers the usual risks that can affect the goods in the property of the insured (fire, earthquake etc.).
- *Unauthorized Trading* (unauthorized transactions) - provides unauthorized transactions that may constitute fraud by computer or fraudulent registrations;
- *General and Other Liability* (general liability and other liabilities).

## 3. Advantages of operational risk insurances

In essence, the role of insurance is to transfer the financial impact of a risk or a combination of risks from one entity to another. Strictly speaking, to transfer risk is not a way to control risk (control includes avoiding, preventing or reducing risk events). By insurance, the financial impact of a risk event is simply transferred to another entity, under the established terms. Concluding insurance against a particular risk, the bank relies on the ability of the insurer to provide compensation according to agreed conditions, so that risk transfer decision can be considered a financing decision.
Insurance as a risk reduction tool, helps the bank to avoid or mitigate the loss (financial or of any other nature) generated by the production of a risk. Theoretically, the benefits that a bank can obtain from contracting insurance against risks are related, on one hand, to the occurrence of a predictable cash flow and, on the other hand, to the avoidance of catastrophic losses.
Large and unpredictable operational losses can dramatically reduce the liquidity of a bank, to exhausting the capital allocated.
By buying a policy of insurance against operational risks, the bank pays an insurance premium in exchange to which it is granted compensation in case of production of a certain risk. This means that insurance against operational risks enables a bank to eliminate or reduce large fluctuations in cash flow caused by high and unpredictable operational losses.
A decrease of cash flow fluctuations also generates other benefits for the bank in that it improves incomes and then increases the bank's market value.
Another advantage refers to avoiding catastrophic situations, by the fact that insurance covers large operational losses that would lead to insolvability.
Although some banks (especially large international ones) have developed their own systems for operational risk management, the practice shows that an insurer has more resources and expertise in this field, acquired as a consequence of administrating a large portfolio of risks taken from clients in various sectors of activity.
By contracting an insurance policy against operational risks, banks transfer the risk to insurers and benefit, on one hand, from effective services and, on the other hand, from a qualified monitoring.
The first aspect is based on the object of activity of an insurer, namely evaluation, control and financing of the risks. Thus, large insurance companies have an advantage over banks from data available, experience and the size of the portfolios of the risks administrated. For banks, it may be more efficient in terms of cost to outsource certain elements of the risk management program to insurance companiesInsurers provide services of damage assessment and coverage, besides legal consulting and administration services (such as the collection of compensation).
The second aspect refers to the fact that, in some cases, shareholders may request the bank management to invest in risk management activities more than the latter would be willing to spend. Therefore, it is difficult for shareholders to monitor management behaviour and make sure it fulfils its tasks. In this case, one possible solution lies in an insurance contract, so that monitoring tasks would be in the insurer’s duty.
The monitoring activity performed by the insurer supports, in fact, the manifestation of market forces. The risk must be regarded as any other commodity and it can be traded. Problems arise when individuals or groups interested in the activity of a bank (e.g. certain shareholders or the management itself) take advantage from the position they hold and expose the others to risks improperly remunerated.

**4. Factors influencing the decision of insurance against operational risks**

The decision of a bank to conclude a contract of insurance against operational risks depends on many factors that influence both the potential benefits it will obtain and the size of insurable risks. Synthetically, these factors regard:

**- The size of bank -** has a major influence on the decision of insurance against operational risks. There are differences of approach between a large bank and a small one, both in terms of potential benefits, and in terms of the insurable risks. It is difficult to judge whether the advantages of the insurance are bigger for one category or for another.
In general, smaller banks have lower equity and free cash flow and, consequently, are more vulnerable to losses from operational risks. Often they have neither a dispersion of risks, nor the funds necessary to develop their own risk management systems to such a degree of complexity that it could equal the monitoring performed under the terms of the insurance contract.
At contrast, large banks have the resources to perform a proper management of operational risks themselves. However, large banks often opt for the insurance solution to protect their income against losses from operational risks, especially when they affect investors' confidence or would lead to the overtaking of that bank.
Putting together and managing large or unusual operational risks of several banks by one insurer is almost always more beneficial than individual administration of those risks within one bank. It is also cheaper for a large bank to transfer the daily administration of relatively common and low-impact risks to an insurer, especially if the market of the insurance for that risk is competitive.
**The bank's risk profile -** the new Basel II agreement states that the level and types of risk identified in various business segments vary. It is possible that these differences affect the nature of the insurability of the risks associated to a business segment (e.g. in default of data and sizes of the losses). Besides determining the size of the minimum capital required, the bank's risk profile also influences its ability to contract itself a good quality and cost advantageous insurance against operational risks.
**- Time horizon for the management / shareholders.** The benefits of insurance require a certain while to become perceptible. If a bank renounces at an insurance contract, it may see a short-term advantage because it saves the insurance premium.
The extent to which a bank can cover the immediate expense of the insurance premium, in exchange for a benefit that may materialize only in the long term, depends on the time horizon the management or the shareholders aim. Those implied on a long term are, generally, more in favour to the solution offered by insurance than those who have immediate interests.
**- The interested parties' attitude towards risk.** The more the groups interested in the activity and the results of a bank (management, shareholders, etc.) show a bigger aversion to risk, the more appealing the solution of the insurance will be to them. The empirical results show that the attitudes toward risks of the groups interested in the bank's activity influence the entire strategy of risk management.
**- Bank rating.** The better the rating, the lower the refinancing cost the bank will support. In such circumstances, banks with very good rating can opt to finance losses by contracting credits rather than insurance. This aspect, though, needs further detailing, as the bank can be immediately demoted when it incurs a considerable loss that was not subject of insurance and, consequently, its access to financing becomes more restrictive.

## 5. The new Basel II agreement - the role of insurances in the management of operational risk and the impact of the required capital of the bank

### *5.1. impact of insurances upon required minimum capital*

Regarding the new Basel II agreement, two acceptations have developed among bankers, related to the impact of insurances on the required minimum capital.
The first implies that any effort to improve the risk management should be viewed independently from the request of capital. Consequently, insurance should not affect the required minimum capital.
The second acceptation implies that, on the contrary, banks have to be provided incentives in order to improve risk management own systems. Consequently, insurance has to be considered

when reckoning the required minimum capital. Many bankers and insurers believe that insurance should be treated as an instrument of reducing the required minimum capital and, in this case, the problem boils down to establishing how much of the insured amount will be deducted from the level of the required capital.

Given the complexity of Basel II, resulting from the recognition of the three criteria for determining the minimum capital level within Pillar I (basic approach, standard approach and the one based on its own system of risk measurement), we need to define, first, the notion of "minimum capital".

Secondly, it should be clarified if a number of instruments, namely insurance contracts concluded by banks, can contribute to the reduction of this required minimum capital.

The second pillar of the Basel II Agreement allows regulators to increase the required capital. Yet, from this perspective, banks should be permitted to rely on the insurances contracted for lowering their capital charge.

The third pillar covers the issue of transparency and control through market forces. Given the benefits of risk monitoring and control, insurance could play a relevant role in the management of banking risks.

Banks with an efficient management could resort to complex insurances of the cart type by which they could assure a higher level of protection and their reporting would improve their rating, driving to the reduction of the cost of the capital raised.

Currently, the market of insurances against operational risks undergoes a process of development and adaptation, so that we can eliminate the disadvantages and maximize the benefits brought to banks. For example, new cart type insurance products provide protection against more risks and solve a part of the problems related to gaps and redundancies arising from the use of traditional insurance.

Basel II agreement needs to provide a flexible framework that allows banks to use insurance as an effective tool for operational risk management.

The new agreement will have to regulate if and to what extent insurance against operational risks is compulsory. For example, the fidelity insurance that cover all risks - operational and non-operational - is mandatory in the U.S.A. and in several other countries (including Britain), which do have reduced schemes of depositors' protection.

From the perspective of the risk management, Basel II agreement should contribute to the production of a competitive environment where market forces could act efficiently and effectively. For this, the regulators should provide regulatory infrastructure and leave the task of monitoring the method of applying regulations to insurance companies and to risk rating agencies.

Insurance companies are very interested to support banks in their bettering of risk prevention and reduction activities. Incidentally, the rating agencies already provide independent external evaluations.

Regulators will be able to direct their limited resources on those banks that have problems from the point of view of the insurers and the risk rating agencies.

One of the objectives of Basel II agreement, that of assuring more transparency to financial environment, could be achieved by publishing the risk rating awarded to banks for the policies of insurance against operational risk, as well as the rating of debt securities. These require, though, a closer cooperation between regulators and the risk rating agencies because, unlike these agencies, public authorities do not publish the awarded ratings.

The regulatory and supervisory authorities collect data on operational risks to determine the required minimum capital and it would be useful that, as far as possible, data should be disseminated to be further useful when concluding insurance contracts and for standardization. This would grant that relevant and properly classified data are considered which would demand a

more rigorous calculation of insurance premiums, fewer exclusion clauses and higher compensation limits.
Basel II Agreement also puts forward the risks associated to outsourced activities such as communication systems and those for payment and settlement302.
The traditional approach used in insurances, the one of covering known risks, generates a series of complaints from banks, because, in the circumstance of alert creation of new products and services, it appears to be essentially reactive. Nevertheless, this reactive attitude allows the emergence of unforeseen gaps in covering operational risks due to changes in technology, knowledge and economic environment situation.
Although a series of renowned international insurers have adopted a pro-active attitude in what the offer of operational risks insurance is regarded, the level of demand for such products is neither known nor easy to estimate. Previously, the insurance companies have created the insurance against fraudulent transactions - considering that it is useful to banks - and found that the demand was virtually non-existent. To avoid situations like those mentioned, you need a constructive dialogue between representatives of banks, insurers and regulatory authorities, in order to clearly identify the products that the market requires and is willing to pay.
At the level of the insurance market, there is a more and more obvious manifestation of the necessity to standardize the documentation for damage in case of losses from operational risk. This would diminish the possibility of disputes and would be a guarantee (for regulators and banks) of the fact that the losses proven will be covered in accordance to the insurance contracted.
This would also help to develop alternative products for protection against risk, because standard products could be traded on the capital market and offered to a much larger public, by means of securitization.
However, a cautious approach is necessary, because an excessive standardization may suppress the development of product and affect the efficient functioning of the market. În plus, schimbarea continua a cererii clientilor face dificila crearea unor polite de asigurare pe deplin standardizate.In addition, the continuous change in the customers' demand makes it difficult to create fully standardized insurance policies.

### *5.2.The attitude of the banks towards the solution of insurance*

When contracting an insurance against operational risks, a bank has to first see to what extent this contributes to the increase of its value on the market and look beyond costs.
Concluding an insurance contract can increase the market value (most frequently measured on the basis of the market price of the actions) by predictability of the cash flow, preventing a financial catastrophe, assistance in monitoring and controlling risks and use of a management instrument of effective risk in what price is regarded.
It is relevant to point out that the simple contracting of an insurance for reducing the required minimum capital does not automatically lead to an increase in the market value of the bank, especially when the opportunity is lower. Contracting an insurance must be justified by the fact that it brings benefits and services the bank cannot develop by itself, under the condition of cost efficiency.
The management of the bank should plead in front of the shareholders for the necessity of concluding insurances against the operational risks, insisting on the fact that these represent an efficient instrument of monitoring and controlling.

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The use of specific insurance policies is in itself a credible signal of undertaking proper management of risks.

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