

## Operational Risk Control with Basel II

Basic principles and capital requirements

Dimitris N. Chorafas



ELSEVIER BUTTERWORTH HEINEMANN

AMSTERDAM BOSTON HEIDELBERG LONDON NEW YORK OXFORD PARIS SAN DIEGO SAN FRANCISCO SINGAPORE SYDNEY TOKYO

## Contents

Foreword Preface Acknowledgements		xi xv xix	
Part	1:	Operational risk is present at any time in every enterprise	1
1	Ma	nagement control of operational risk	3
	1.1	Introduction	3
	1.2	The presence of operational risk in an organization	4
	1.3	The management of operational risk events	8
	1.4	Supervisory response to operational risk	11
	1.5	A strategy for bringing operational risk under control	14
	1.6	Operational risk must be managed at all organizational levels	18
	1.7	Turning operational risk control into a senior management tool	21
2	Cla	ssification, identification and monitoring of operational risk	26
	2.1	Introduction	26
	2.2	Basel Committee directives in understanding operational risk	27
	2.3	Classification of operational risks and the Basel Committee	30
	2.4	A classification and identification system for operational risks	32
	2.5	The Chorafas parallel code system as an organizational	
		infrastructure	35
	2.6	Quantitative and qualitative approaches to operational risk	
		identification	37
	2.7		40
	2.8	1 0	42
	2.9		
		management	44
3	Leg	al risk	49
	3.1	Introduction	49
	3.2	Back to basics: the definition of tort	50
	3.3	Responsibilities resulting from legal risk	52
	3.4	Contractual aspects of legal risk	55
	3.5	Crossborder legal risk and bankruptcy laws	58
	3.6	Legal risk may be an impediment to a solution to a banking crisis	61
	3.7	Huge credit losses, securitized corporates and legal risk	63
	3.8	Compliance risk: a case study with the Year 2000 problem	66

4	Man	agement risk	70
	4.1	Introduction	70
	4.2	Management risk in the power crisis in the United States	71
	4.3	The changing nature of energy business calls for high grade	
		management skill	74
	4.4	An operational risk which morphs into major credit risk	76
	4.5	The derivatives losses of EDS: a different management risk	78
	4.6	Management risk at Tyco International	82
	4.7	The CEO should be an example of virtue, not of malfeasance	85
	4.8	Conflicts of interest: from IPOs to disappearing technology firms	87
5	Info	rmation technology risk	90
-	5.1	Introduction	90
	5.2	Technology risk defined	91
	5.3	The growing role of IT and its risks	95
	5.4	Advanced IT solutions and smart environments	98
	5.5	Business continuity and IT-related operational risk	102
	5.6	System reliability should always be a major objective	102
	5.0 5.7	Trading, payments, settlements, and operational risk associated	105
	5.7	to IT	109
	5.8	Operational risks that may result from IT outsourcing and	109
	5.0		111
		insourcing	111
Part	t 2:	Capital requirements for operational risk and Basel II solutions	115
Part 6		Capital requirements for operational risk and Basel II solutions cation of capital to operational risk according to Basel II	115 117
	Allo	cation of capital to operational risk according to Basel II	117
	<b>Allo</b> 6.1	cation of capital to operational risk according to Basel II Introduction Regulatory capital vs economic capital	<b>117</b> 117
	<b>Allo</b> 6.1 6.2	cation of capital to operational risk according to Basel II Introduction Regulatory capital vs economic capital Economic capital and levels of confidence	<b>117</b> 117 118
	Allo 6.1 6.2 6.3 6.4	cation of capital to operational risk according to Basel II Introduction Regulatory capital <i>vs</i> economic capital Economic capital and levels of confidence A bird's-eye view of models for operational risk reserves	<b>117</b> 117 118 120 124
	Allo 6.1 6.2 6.3 6.4 6.5	cation of capital to operational risk according to Basel II Introduction Regulatory capital vs economic capital Economic capital and levels of confidence A bird's-eye view of models for operational risk reserves The choice among methods for operational risk modeling	<b>117</b> 117 118 120 124 128
	Allo 6.1 6.2 6.3 6.4 6.5 6.6	cation of capital to operational risk according to Basel II Introduction Regulatory capital <i>vs</i> economic capital Economic capital and levels of confidence A bird's-eye view of models for operational risk reserves The choice among methods for operational risk modeling Capital standards and operational risk control costs	<b>117</b> 117 118 120 124
	Allo 6.1 6.2 6.3 6.4 6.5	cation of capital to operational risk according to Basel II Introduction Regulatory capital vs economic capital Economic capital and levels of confidence A bird's-eye view of models for operational risk reserves The choice among methods for operational risk modeling Capital standards and operational risk control costs Allocating regulatory capital and economic capital to operational	<b>117</b> 117 118 120 124 128 131
	Allo 6.1 6.2 6.3 6.4 6.5 6.6 6.7	cation of capital to operational risk according to Basel II Introduction Regulatory capital vs economic capital Economic capital and levels of confidence A bird's-eye view of models for operational risk reserves The choice among methods for operational risk modeling Capital standards and operational risk control costs Allocating regulatory capital and economic capital to operational risk	<b>117</b> 117 118 120 124 128 131
	Allo 6.1 6.2 6.3 6.4 6.5 6.6	cation of capital to operational risk according to Basel II Introduction Regulatory capital vs economic capital Economic capital and levels of confidence A bird's-eye view of models for operational risk reserves The choice among methods for operational risk modeling Capital standards and operational risk control costs Allocating regulatory capital and economic capital to operational	<b>117</b> 117 118 120 124 128 131
	Allo 6.1 6.2 6.3 6.4 6.5 6.6 6.7 6.8 6.9	cation of capital to operational risk according to Basel II Introduction Regulatory capital <i>vs</i> economic capital Economic capital and levels of confidence A bird's-eye view of models for operational risk reserves The choice among methods for operational risk modeling Capital standards and operational risk control costs Allocating regulatory capital and economic capital to operational risk Capital at risk with operational type losses: a case study Operational risk control at the Erste Bank	<b>117</b> 117 118 120 124 128 131 133 135 138
	Allo 6.1 6.2 6.3 6.4 6.5 6.6 6.7 6.8 6.9 Five	cation of capital to operational risk according to Basel II Introduction Regulatory capital <i>vs</i> economic capital Economic capital and levels of confidence A bird's-eye view of models for operational risk reserves The choice among methods for operational risk modeling Capital standards and operational risk control costs Allocating regulatory capital and economic capital to operational risk Capital at risk with operational type losses: a case study Operational risk control at the Erste Bank	<b>117</b> 117 118 120 124 128 131 133 135 138 <b>141</b>
	Allo 6.1 6.2 6.3 6.4 6.5 6.6 6.7 6.8 6.9 Five 7.1	<ul> <li>cation of capital to operational risk according to Basel II Introduction Regulatory capital vs economic capital Economic capital and levels of confidence A bird's-eye view of models for operational risk reserves The choice among methods for operational risk modeling Capital standards and operational risk control costs Allocating regulatory capital and economic capital to operational risk Capital at risk with operational type losses: a case study Operational risk control at the Erste Bank</li> <li>e models by the Basel Committee for computation of operational risk Introduction</li> </ul>	<b>117</b> 117 118 120 124 128 131 133 135 138
	Allo 6.1 6.2 6.3 6.4 6.5 6.6 6.7 6.8 6.9 Five	<ul> <li>cation of capital to operational risk according to Basel II Introduction Regulatory capital vs economic capital Economic capital and levels of confidence A bird's-eye view of models for operational risk reserves The choice among methods for operational risk modeling Capital standards and operational risk control costs Allocating regulatory capital and economic capital to operational risk Capital at risk with operational type losses: a case study Operational risk control at the Erste Bank</li> <li>e models by the Basel Committee for computation of operational risk Introduction The effort to measure operational risk and the basic indicator</li> </ul>	<ul> <li>117</li> <li>118</li> <li>120</li> <li>124</li> <li>128</li> <li>131</li> <li>133</li> <li>135</li> <li>138</li> <li>141</li> <li>141</li> </ul>
	Allo 6.1 6.2 6.3 6.4 6.5 6.6 6.7 6.8 6.9 Five 7.1 7.2	<ul> <li>cation of capital to operational risk according to Basel II Introduction Regulatory capital vs economic capital Economic capital and levels of confidence A bird's-eye view of models for operational risk reserves The choice among methods for operational risk modeling Capital standards and operational risk control costs Allocating regulatory capital and economic capital to operational risk Capital at risk with operational type losses: a case study Operational risk control at the Erste Bank</li> <li>e models by the Basel Committee for computation of operational risk Introduction The effort to measure operational risk and the basic indicator approach</li> </ul>	<b>117</b> 117 118 120 124 128 131 133 135 138 <b>141</b> 141 142
	Allo 6.1 6.2 6.3 6.4 6.5 6.6 6.7 6.8 6.9 Five 7.1 7.2 7.3	<ul> <li>cation of capital to operational risk according to Basel II Introduction Regulatory capital vs economic capital Economic capital and levels of confidence A bird's-eye view of models for operational risk reserves The choice among methods for operational risk modeling Capital standards and operational risk control costs Allocating regulatory capital and economic capital to operational risk Capital at risk with operational type losses: a case study Operational risk control at the Erste Bank</li> <li>models by the Basel Committee for computation of operational risk Introduction The effort to measure operational risk and the basic indicator approach Capital charges under the Basel Committee's standard approach</li> </ul>	<b>117</b> 117 118 120 124 128 131 133 135 138 <b>141</b> 141 142 145
	Allo 6.1 6.2 6.3 6.4 6.5 6.6 6.7 6.8 6.9 Five 7.1 7.2 7.3 7.4	<ul> <li>cation of capital to operational risk according to Basel II Introduction Regulatory capital <i>vs</i> economic capital Economic capital and levels of confidence A bird's-eye view of models for operational risk reserves The choice among methods for operational risk modeling Capital standards and operational risk control costs Allocating regulatory capital and economic capital to operational risk Capital at risk with operational type losses: a case study Operational risk control at the Erste Bank</li> <li>e models by the Basel Committee for computation of operational risk Introduction The effort to measure operational risk and the basic indicator approach Capital charges under the Basel Committee's standard approach The effort to develop advanced measurement approaches</li> </ul>	<b>117</b> 117 118 120 124 128 131 133 135 138 <b>141</b> 141 142 145 150
	Allo 6.1 6.2 6.3 6.4 6.5 6.6 6.7 6.8 6.9 Five 7.1 7.2 7.3 7.4 7.5	<ul> <li>cation of capital to operational risk according to Basel II Introduction Regulatory capital <i>vs</i> economic capital Economic capital and levels of confidence A bird's-eye view of models for operational risk reserves The choice among methods for operational risk modeling Capital standards and operational risk control costs Allocating regulatory capital and economic capital to operational risk Capital at risk with operational type losses: a case study Operational risk control at the Erste Bank</li> <li>e models by the Basel Committee for computation of operational risk Introduction The effort to measure operational risk and the basic indicator approach Capital charges under the Basel Committee's standard approach The effort to develop advanced measurement approaches Capital allocation with the loss distribution approach</li> </ul>	<b>117</b> 117 118 120 124 128 131 133 135 138 <b>141</b> 141 141 142 145 150 152
	Allo 6.1 6.2 6.3 6.4 6.5 6.6 6.7 6.8 6.9 Five 7.1 7.2 7.3 7.4	<ul> <li>cation of capital to operational risk according to Basel II Introduction Regulatory capital <i>vs</i> economic capital Economic capital and levels of confidence A bird's-eye view of models for operational risk reserves The choice among methods for operational risk modeling Capital standards and operational risk control costs Allocating regulatory capital and economic capital to operational risk Capital at risk with operational type losses: a case study Operational risk control at the Erste Bank</li> <li>e models by the Basel Committee for computation of operational risk Introduction The effort to measure operational risk and the basic indicator approach Capital charges under the Basel Committee's standard approach The effort to develop advanced measurement approaches</li> </ul>	<b>117</b> 117 118 120 124 128 131 133 135 138 <b>141</b> 141 142 145 150

High	n frequency events, low frequency events and the Six Sigma method	163
8.1	Introduction	163
8.2	Understanding the concepts of high frequency and low frequency	
	events	164
8.3	Characteristics of high frequency and low frequency events	168
8.4	Experimentation and system design for operational risk control	170
8.5	Tools most useful in the analysis of operational risks	174
8.6	Using Six Sigma to improve management control over operations	177
8.7	The practical applications of Six Sigma are convincing	180
Mar	ket discipline, contrary opinion and Scoreboard solutions	184
9.1	Introduction	184
9.2	The Basel Committee on scoreboards and market discipline	185
9.3	The use of templates with scoreboards	188
9.4	Developing more sophisticated Scoreboard practices	191
9.5	Extreme value theory and genetic algorithms for operational risk	
	control	195
9.6	A common project on operational risk by a group of financial	
	institutions	198
9.7	A devil's advocate in operational risk management	202

Part	3: Control of technical risk and operational risk in the insurance industry	207
10	The science of insurance and the notion of technical risk	209
	10.1 Introduction	209
	10.2 The science of insurance	210
	10.3 Definition of risk factors and their aftermath	213
	10.4 Underwriting risk in insurance and the actuaries	216
	10.5 Assets held by insurers and their risks	219
	10.6 The insurance of operational risk and its underwriting	223
	10.7 Services provided by reinsurance: a proxy for insurance of	
	operational risk	226
11	The use of insurance policies to mitigate operational risk	230
	11.1 Introduction	230
	11.2 Cost of equity, cost of debt, and cost of insurance	231
	11.3 Operational risk securitization and moral hazard	233
	11.4 Advent of insurance-linked protection vehicles and underwriters	
	risk	237
	11.5 Integrative approaches through alternative risk transfer (ART)	240
	11.6 Frequency and impact of events in operational risk transfer	
	through insurance	243
	11.7 Insurers who don't do their homework get burned	245
	11.8 Challenges with value accounting in the insurance business	247

251

	12.1	Introduction	251
	12.2	Independent rating agencies, their business and their role	253
		Insurance companies and independent rating agencies	255
		Qualitative and quantitative approaches to rating insurance	
		companies	259
	12.5	Information is the critical product of rating agencies	262
		Analytical studies are the way of being in charge of risks	266
		Operational risk with marine insurance underwriting:	
		a case study	268
13	Tort	is technical and operational risk of insurers	274
		Introduction	274
	13.2	Why tort reform is necessary	275
		Learning from the precedent of Y2K tort	277
		Compensation for claims: a case study with asbestos	279
		Asbestos claims have been a nightmare to the insurance industry	281
		Challenges facing major financial institutions and their daily	
		business	284
	13.7	Tort exposure and management risk correlate	287
14	The	challenge of terrorism and insurer of last resort	290
		Introduction	290
		Business disruption resulting from 9/11	292
		Learning from technical limits with insurance of natural	294
	1 4 4	catastrophes	
		Policies for rethinking insurability of operational risks	298
		Benefits catastrophe bonds might provide	301
	14.6	Lloyd's record losses with 9/11: a prognosticator of future	202
	147	red ink?	303
	14.7	Governments as insurers of last resort: a precedent with	
		deposit insurance	307
Par	t 4 ]	The importance of cost-consciousness in operational risk control	311
15	Defi	cient cost control is the result of management risk	313
		Introduction	313
		The low cost producer holds the upper ground	314
		Alert companies are in charge of their risks and of their costs:	511
	10.0	Berkshire and TIAA	319
	15 /	An example of controllable technology spending	322
		Isaac Newton appreciated that throwing money at the problem	544
	15.5	leads nowhere	324
	15.6	Putting into action a costing and pricing mechanism for	324
	15.0	operational risk control	328
		operational fisk control	520

12 Role of rating agencies in the creditworthiness of insurance firms

16	Cost control is indivisible from operational risk management	331
	16.1 Introduction	331
	16.2 The cost of staying in business	332
	16.3 Operational risk control and the administrative budget	334
	16.4 Are mergers and disinvestments a good way to cut costs?	338
	16.5 Why fat executive options work against shareholder value	341
	16.6 What it means to be in charge of re-engineering	343
	16.7 Establishing and sustaining a transnational advantage	346
	16.8 Capitalizing on the evolving role of financial instruments	348
Ind	ex	351