Why the Current Practice of Operational Risk Management in Insurance is Fundamentally Flawed: Evidence from the Field

Dr. Madhu Acharyya

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Dr. Madhu Acharyya

macharyya@bournemouth.ac.uk

The Business School, Bournemouth University, Executive Business Centre, 89 Holdenhurst Road, BH8 8EB, Bournemouth, U.K.

Abstract

This paper evaluates the current practice of operational risk management in the insurance sector. Operational risk is nothing new in insurance, but, because of regulatory requirements, companies have initiated computation of risk capital for their operational losses. The current effort to manage operational risk is not a naturally evolving phenomenon, and operational risk, in the Basel Committee on Banking Supervision's Basel II definition, is unlikely to be a significant cause of insurers' failure. In addition, the current Basel II definition of operational risk is not suitable for the insurance sector. Consequently, the invention of models and tools based on the definition is incomplete and illusionary. My findings are based on the analysis of dozens of interviews with insurance industry professionals. I demonstrate the way operational risk is quantified in practice, show that the result obtained from this computation is of little use in managerial decision making and propose a set of policy recommendations illustrating the characteristics of operational risk in insurance. This study can be used as a platform for launching dialogues to initiate fresh thinking about operational risk in insurance beyond the current artificial and narrow boundaries.
