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Should the Insurance Industry be Banking on Risk Escalation for Solvency

II?

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Abstract

Basel II introduced a three pillar approach which concentrated upon new capital ratios (Pillar I), new supervisory procedures (Pillar II) and demanded better overall disclosure to ensure effective market discipline and transparency. Importantly, it introduced operational risk as a standalone area of the bank which for the first time was required to be measured, managed and capital allocated to calculated operational risks. Concurrently, Solvency II regulation in the insurance industry was also re-imagining regulations within the insurance industry and also developing operational risk measures. Given that Basel II was first published in 2004 and Solvency II was set to go live in January 2014. This paper analyses the strategic challenges of Basel II in the UK banking sector and then uses the results to inform a survey of a major UK insurance provider. We report that the effectiveness of Basel II was based around: the reliance upon people for effective decision making; the importance of good training for empowerment of staff; the importance of Board level engagement; and an individual's own world view and perceptions influenced the adoption of an organizational risk culture. We then take the findings to inform a survey utilizing structural equation modelling to analyze risk reporting and escalation in a large UK insurance company. The results indicate that attitude and uncertainty significantly affect individual's intention to escalate operational risk and that if not recognized by insurance companies and regulators will hinder the effectiveness of Solvency II implementation.

Keywords: Operational Risk, Risk Escalation, Risk Regulation, Basel II, Solvency II.

JEL: G2, L1, L2, L5, N2

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