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What is a Fair Price to Transfer the Risk of Unauthorized Trading?: A Case Study on Pricing Operational Risk

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Abstract

Over the course of the past decade, the financial press is replete with stories of "rogue" traders that surreptitiously bypassed internal controls and engaged in "unauthorized trading" - ultimately resulting in hundreds of millions, if not billions, of dollars in losses at financial institutions. The victims of this financial chicanery - cases like Daiwa Bank, Barings PLC, Allied Irish Bank, and National Australia Bank - are well known to risk managers worldwide. Now, as financial institutions increasingly focus their attention on the management and measurement of operational risk, risk managers are gaining an appreciation for the fact that unauthorized trading losses are a very real risk that requires active management.

Given the importance of managing unauthorized trading risks, this paper explores why unauthorized trading insurance has failed to evolve as a viable alternative for managing a bank's unauthorized trading risks. Interestingly, this study finds that a key obstacle in the development of the market for unauthorized trading insurance is a fundamental difference in how banks and insurance companies value unauthorized trading risks. In an attempt to bridge this gap, this paper utilizes historical loss event data on unauthorized trading losses and a discrete time asset-pricing framework to illustrate a consistent framework for valuing the risk of unauthorized trading. Using this approach, the paper develops representative prices for unauthorized trading policies written against a variety of underlying asset portfolio compositions and compares these prices with current rates-on-line in the insurance market.

Keywords: Operational Risk, Insurance, Asset Pricing

JEL Classification: G21, G22, G12

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