In this chapter, we discuss the three pillars of operational risk management: capital allocation, transfer of operational risk through insurance, and proactive mitigation of operational risk through product inspection and quality control. Thorough operational risk management will generally involve all three pillars. While the first two pillars are fairly well understood and have been the subject of attention from the Basel Committee and other regulatory bodies, the third pillar is equally important though less familiar to those tasked with operational risk management. Regardless of which pillar an institution elects to rely on for operational risks in general or for a particular operational risk, the procedure to begin managing operational risk is the same.

**Approaches to managing operational risk**

As mentioned in chapter 1, properly addressing operational risk requires a financial institution to implement a thorough risk-management system consisting of several steps. These steps include identifying the risk, quantifying the risk to the extent possible, and then determining the best approach to take to contain the risk, which may involve some combination of holding capital, transferring all or part of the risk,
or actively mitigating the risk. Of course, an organization that must contend with an operational risk in a specific line of business also has the option of avoiding the line of business that is creating the risk, or simply accepting the risk as a cost of doing business—that is, do nothing about it. This latter option happens to be the default option for all risks the institution fails to identify. While using this default option, whether by choice or through ignorance, may be acceptable for low-frequency, low-severity risks, it could prove very costly or even fatal to an institution for even one catastrophic operational risk event.

Once a financial institution elects to undertake a particular line of business, then it has three ways to manage and mitigate the operational risks that accompany that line of business. The institution may (1) hold capital to absorb losses from operational failures, (2) purchase insurance or adopt some other risk-transfer strategy, or (3) attempt to identify and correct operational hazards that are increasing operational risk. In this chapter, we briefly discuss these approaches to operational risk management, including current capital rules as they apply to different financial institutions. A particular application of the third approach, proactive risk containment that includes sampling and inspection methodologies, is the focus of chapters 3 and 4.

**Capital**

Although operational risk has always been a part of doing business, specifically accounting for operational risk is a relatively new undertaking for financial institutions. Prior to the initial proposal of the Basel II capital rules in 2004, financial institutions did not have any specific regulation-based capital requirements tied to operational risk. Although banks have always had to manage operational risk and account for