

Operational risk in the new Basel framework

4 Connected control and risk frameworks

A new standardized approach introduced by the Basel committee has led to a number of changes for banks, with implications for how they manage their capital. Slim Ben Ali assesses its impact on financial institutions' levels of operational and regulatory risk.

Following a one-year deferral due to the Covid-19 pandemic, the Basel committee has introduced a standardized approach effective January 2023, building upon previous Basel accords, with the aim to strengthen risk management, regulation, supervision, and stability within the banking industry.

Currently, banks can choose the approach to take for calculating operational capital, with the possibility of capital savings in return for higher investments in risk management. Under the new Basel accord, banks will have to use a revised standardized approach (SA) to calculate the minimum operational risk capital requirements. This approach will replace all three existing approaches for operational risk under Pillar 1.

As with all Basel committee standards, the new SA applies to all internationally active banks on a consolidated basis, and national supervisors may also apply the framework to non-internationally active banks.

The new approach seeks to restore credibility in the calculation of risk weighted assets (RWAs) and to improve the comparability of banks' capital ratios. It is therefore critical that banks maintain high quality operational risk teams, use processes such as risk modeling and scenario analysis to assist with business

decision making, and embed operational risk management mindsets into the business.

Components of the new standardized approach

The new formula for the standardized approach consists of two main components – a business indicator component (BIC) (a measure of a bank's income) and a loss component (LC), from which an internal loss multiplier (ILM) is derived, a measure of a bank's historical losses. The minimum (pillar 1) operational risk capital (ORC) requirement is the product of the BIC and the ILM, with risk weighted assets for operational risk being the capital requirement multiplied by 12.5.

This shift has major implications for banks' internal loss data and how it could be used to derive business value and risk management insight.

In practical terms, the ILM is the only variable a bank has significant control over, but its impact can be crucial and the new formula is predicted to affect banks to varying degrees.

Given the fact that the revised operational risk framework will not take effect until 1 January 2023, banks have time to improve their processes for collecting, managing, and analyzing internal loss data to reduce their ILM and thus the ORC.

Implications for banks

The implementation of the new standardized approach framework will have potential impact on the bank's data, systems, business models and capital.

— Data, systems and processes:

Banks will have to ensure their internal loss data collection processes are sufficiently robust and cover the required ten-year history. Banks must have robust processes for appropriately capturing operational risk loss data, including loss dates, accounting dates and recovery data. They may need to invest in training and incentive schemes for individuals involved in LC, in data quality processes and in documentation to ensure that LC is of a sufficiently high quality. Moreover, risk management teams will need to work together with finance to define exactly how the components of the business indicator are derived from the profit and loss accounts.

Documented policies and procedures for identifying and reporting operational risk events must serve as the starting point for managing data capture and quality. Associated procedures and processes must be validated before a bank's loss data can be used to calculate capital charge for operational risk. Regular independent reviews by corporate internal audit functions and external independent party are also required.

Many banks already have systems for capturing operational loss data but with the new framework, banks may need to enhance their existing system to capture all the required operational loss data elements. Banks will also need to continue to

have independent assurance that operational loss tracking systems, processes, and controls provide for high quality data.

Exploring the latest advances in robotic process automation (RPA) and cognitive technology to streamline and automate routine activities, such as data collection, cleansing, and storage can be also something that banks may consider in the future.

— Business model and capital:

The definition of the BIC – as compared to gross income currently used for calculating the simpler pillar 1 approaches – generates higher capital requirements for some business activities. Banks would do well to analyze their different business lines to ensure they remain sustainable in all aspects (including profitability, customer expectations and capital usage). Moreover, due to the bucketing of the business indicator, larger banks are expected to face higher capital charges compared to smaller ones, which might have an influence on strategic decisions, especially those related to achieving non-organic growth through mergers and acquisitions.

Although the new framework will not come into force until 2023, all banks should ensure they are incorporating the new approach into their capital planning process, as well as in risk adjusted return measures at an early stage.

Implementing the new approach

The Basel Committee on Banking Supervision (BCBS) has introduced a single non model-based method for calculating operational risk capital, the SA. This will replace all three existing approaches for operational risk under Pillar 1 and will become effective starting 1st January 2023.

The main objectives of the BCBS in defining this new framework were to improve comparability and simplicity, which might be challenging given the scope of national discretion and the use of opaque Pillar 2 capital requirements. We expect a high level of variability in capital impact across banks and across jurisdictions under the new approach. Nevertheless, we believe that it will have significant impact on the way banks manage operational risk and presents a valuable opportunity for financial institutions to embrace new technologies and techniques including big data analytics and predictive risk intelligence.



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