MARSH

April 2016

CLIENT ADVISER

THE BASEL COMMITTEE'S NEW APPROACH TO OPERATIONAL RISK CAPITAL IN BANKS

On March 4, the Basel Committee on Banking Supervision (BCBS) released a consultative document proposing the introduction of a new Standardised Measurement Approach (SMA) for operational risk – to be applied to all internationally active banks and to some which are only active within their home jurisdiction.

Under this proposal, the SMA will not only replace the two existing simplified approaches, the Basic Indicator Approach and the Standardised Approach, but also the Advanced Measurement Approach (AMA). The committee stated that this was done in order to address the problem of "excessive variability in risk weighted assets and insufficient capital levels for some banks".

The stated goal of the BCBS is to promote the comparability of risk-based capital measures and reduce model complexity while retaining adequate risk sensitivity. The SMA capital charge is driven by balance sheet metrics adjusted by a factor derived from past operational loss experience:

- The business indicator (BI) will be the sum of net interest income, net fee, and other operating income, plus net profit on the trading books and banking books. To prevent volatility, each component of the BI is calculated as a rolling three-year average. The BI is then multiplied by one of a set of escalating coefficients based on the size of the bank. This assumes that the relationship between operational risk exposure and size increases in a non-linear fashion.
- In an attempt to make the risk charge reflective of a bank's own experience, banks are required to have tracked their own operational risk losses for at least five years (during a transition period) and preferably ten years. This data then flows into a "loss component".
- The BI divided by the loss component gives rise to the internal loss multiplier. A bank which sits within the industry average loss experience should find that internal loss multiplier divided by BI = approximately one. So an average bank would multiply its BI by its internal loss multiplier (one) to find that its operational risk capital equalled its BI.

EARLY OBSERVATIONS

- To date, banks have derived a forward-looking measure of operational risk from the modelling of scenarios. In a globalised economy where banks are required to evolve swiftly, it would seem important to have such a forward-looking metric. Nevertheless, the consultative document is silent on the use of scenarios and scenario modelling to identify and quantify emerging risks, meaning that any assessment of emerging risk would be absent from the capital calculation.
- The requirement to track operational loss experience, which then flows into the capital calculation via the multiplication factor, may create a perverse incentive to re-classify marginal loss events as credit or market losses rather than as operational losses which might negatively impact the capital charge. Equally, banks may seek to aggregate losses to a single event that is outside the ten year window or close to being retired.
- Where a loss event occurs and the bank is able to make recoveries from third parties (for example, insurance), the bank is nevertheless required to report the loss as though there were no recoveries (i.e. gross of recoveries from counterparties or insurance). This would likely lead to loss events being artificially inflated for purposes of the capital calculation and thus penalise banks which have made appropriate risk provisions.
- The charge as proposed does not incentivise banks to measure or manage their operational risks. Some national regulators may therefore be reluctant to implement the change. This would lead to a two-speed capital regime which might unfairly disadvantage internationally active banks located in early-moving jurisdictions.

CONCLUSION

While regulators have tried hard to make the SMA risk sensitive, it remains a standardised approach which will, by design, imperfectly capture the risk of any given institution. The Basel Committee's mandate is to strengthen the regulation, supervision and practices of banks worldwide with the purpose of enhancing financial stability[1]. We believe that its approach to enhancing financial stability should not just focus on the capital amount banks hold but also incentivise banks to better measure and manage their risk.

The unintended consequence of disconnecting the capital charge from the sound management of operational risk could be that some institutions will be tempted to privatise the gains and "socialise the losses" (stick the tax-payer with the bailout bill). Some form of compromise can hopefully be achieved that will retain the modelling requirement while using the SMA as a floor to ensure a reduction in the variability of capital numbers across institutions and jurisdictions.

Finally, a decade of usage under the existing AMA regime has provided ample proof that insurance is an effective mitigant of operational risk. Against this background, the seeming excision of insurance mitigation from the Pillar 1 operational risk charge must be a source of concern to AMA banks.

We will be consulting with clients to build consensus around possible alternative proposals which might serve the goals of:

1. Embedding sound operational risk measurement and management in the capital regime going forward.
2. Ensuring that scenario modelling continues to provide a forward looking measure of risk.
3. Retaining insurance as part of the capital framework for operational risk.

The consultation is open for comment until June 3, 2016.

CONTACTS:

SHIRLEY BEGLINGER
Operational Risk Coordinator
Marsh UK

EVAN SEKERIS
Partner
Oliver Wyman US

1 Basel Committee on Banking Supervision Charter, January 2013

GRAPHICS NO. 16-0275