Basel Committee on Banking Supervision Consultative Document Operational Risk – Revisions to the Simpler Approaches

Marianne Ojo[1]

A Introduction

According to the Basel Committee's Consultative Document,[2] weaknesses in current approaches to operational risk, which constitute part of the rationales for revisions to the present framework, are to be accomplished through:[3]

- refining the operational risk proxy indicator by replacing Gross Income (GI) with a superior indicator;
- and improving calibration of the regulatory coefficients based on the results of the quantitative analysis.

Other reasons which have been played a contributory role in the Committee's consideration to adopt a simple and comparable approach include results obtained from analyses whereby the following were highlighted:[4]

- the original Basel II business lines did not differ significantly in terms of their operational risk profiles;
- the size of a bank was a dominant factor in operational risk exposure;
- and refinements to the proxy indicator could enhance risk sensitivity.

The Need to Account Adequately for Off Balance Sheet Exposures

As is the case with the Standardised Approach to Counterparty Credit Risk (SA-CCR), one of the aims of introducing the revisions to the present framework on operational risk, includes namely, the need

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[1] Professor, Faculty of Commerce and Administration, North West University Email: marianne ojo@hotmail.com

[2] See Basel Committee on Banking Supervision, Consultative Document "Operational Risk: Revisions to the Simpler Approaches", October 2014 http://www.bis.org/publ/bcbs291.htm at page 2

[3] ibid

[4] "It was therefore considered appropriate to develop only one approach based on a single indicator of operational risk exposure with size-based coefficients. A single non-model-based approach also addresses the Committee's objectives of promoting simple and comparable approaches while still maintaining risk sensitivity." see ibid

to adequately account for exposures, and particularly, off- balance sheet exposures related to banking activities.

The Standardised Approach for Measuring Counterparty Credit Risk exposures (SA-CCR) replaced the Current Exposure Method and the Standardised Method as these were criticised for not adequately capturing "the level of volatilities as observed over recent stress periods."[5] The conversion of off balance sheet items into credit exposure equivalents were facilitated by the Basel Committee's January 2014 revised leverage ratio standard.

It was also highlighted by the Committee that weaknesses of the simpler approaches were attributed and generated principally from the use of Gross Income (GI) as a proxy indicator for operational risk exposure - "based on the assumption that banks' operational risk exposure increases linearly in proportion to revenue."[6]

B Replacing the the Gross Income Indicator with the Business Indicator

The Business Indicator (BI) was identified by the Basel Committee as the most suitable replacement for GI, since it addresses most of the GI's weaknesses, as well as possesses the following attributes which were also highlighted to have been at the heart of the recent Financial Crisis:[7]

- it includes items sensitive to operational risk that are omitted or netted from the GI definition;
- uses the absolute values of its components, thereby avoiding counterintuitive results based on negative contributions of components to capital charges from net losses under the existing framework;
- reduces the relative weight or contribution of components of the financial statement that are associated with activities traditionally less exposed to operational risk, and increases that of the components associated with activities more closely associated with operational risk

[5] See Basel Committee on Banking Supervision, "The Standardised Approach for Measuring Counterparty Credit Risk Exposures (March 2014) at page 1 Available at http://www.bis.org/publ/bcbs279.htm

[6] See Basel Committee on Banking Supervision, Consultative Document "Operational Risk: Revisions to the Simpler Approaches", October 2014 at page 1

[7] see ibid "The BI comprises the three macro-components of a bank's income statement: the "interest component", the "services component", and the "financial component".

Furthermore, the BI's power, according to the Committee, as compared with GI and other potential indicators, lies in "its superior ability to capture a bank's exposure to the operational risk inherent in a bank's mix of business activities."

As is the case with the Standardised Approach to Counterparty Credit Risk, main issues revolve around the most efficient mode of capturing off balance sheet exposures, as well as the determination of the frequency of calculations - such that inaccurate measures or estimates or the inability to adequately account for such exposures, does not result in the severe under capitalisation of banks. Hence, the focus, it would seem, should concern accuracy of measures. Even though considerable efforts have been undertaken in the choice of determining the Business Indicator as replacement for the Gross Income, it appears that a lot of focus has also been given towards the goal of attaining simplicity, comparability and consistency. These could be particularly difficult given the institution specific attributes inherent in the nature of operational risks.

As indicated by the Committee, " in order for an indicator to be an effective proxy of operational risk for regulatory purposes, it is crucial that specific banking characteristics are captured by its components……."[8]

C Achieving Simplicity and Comparability of Outcomes Within the Framework

Principles taken into consideration in formulating the revised standardised approach, as stated by the Committee, are as follows:[9]

- There should be only one simple approach given the need to ensure simplicity and comparability of outcomes in the framework;
- The approach should address the known weaknesses of the existing simpler approaches while retaining the fundamental attributes of the current framework;
- It should be simple enough to understand, not unduly burdensome to implement, should not have too many parameters for calculation by banks and it should not rely on banks' internal models;
- It should exhibit enhanced risk sensitivity;
- It should be calibrated according to the operational risk profile of a large number of banks of different size and business models; and
- It should be suitable for implementation across a wide range of jurisdictions and banks.

[8] see ibid at page 30
[9] see ibid at page 7

Whilst the goals of simplicity and comparability resonate strongly from the first and third of the above-mentioned principles, the need for improved risk sensitivity and specificity, is also highlighted.

Improved risk sensitivity would appear to denote improved accuracy - provided such risk sensitivity is not unwarranted or excessive. Trade-offs will definitely be required since simplicity and comparability will also demand that less complex approaches (complex approaches which may enhance risk sensitivity and specificity) should be adopted.

In addition, the growing importance of compliance with Basel rules and principles is also evident, not only as a result of recent surveys and findings thereof,[10] but also as evidenced by the Binding Technical Standards (BTS) which are being introduced and generated by the European Banking Authority, as its plays a crucial role in the implementation of Basel III.

According to the Basel Committee, the Basel framework recognises that capital is not a substitute for effective controls and risk management processes. "Rather, strong and effective risk management and internal control processes help reduce the capital that a bank needs to hold against its operational risks. An emphasis on sound management of operational risk to ensure financial soundness of banks is consistent with the uncertainties in the current capital measurement methodologies for operational risk, which are improved but still evolving toward maturation…."[11]

As well as an effective compliance culture, an adequate and appropriate focus on the third pillar of Basel II is vital in ensuring that the objectives of other pillars are achieved. A lot of observations and comments have been made over the years in relation to the seemingly and relatively low attention accorded to the third pillar - in comparison to Pillars I and II.

Hence the Committee's observations in the Consultative Document that "banks should regularly report operational risk exposures, including material operational losses, to business unit management, senior management, and to the board of directors and that the reporting should be actionable and support decision making", should be very welcomed.[12]

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[10] Basel Committee on Banking Supervision, Review of the Principles for the Sound Management of Operational Risk 6 October 2014
http://www.bis.org/publ/bcbs292.pdf

[11] See Basel Committee on Banking Supervision, Consultative Document "Operational Risk: Revisions to the Simpler Approaches", October 2014 at page 16

[12] See ibid at page 46

D The Importance of Disclosures: Achieving Capital Adequacy Objectives

The complementary function of Pillar III (market discipline) to the other two pillars (minimum capital requirements and supervisory review) is highlighted in the Basel Committee's comprehensive version of the revised framework for Basel II.[13] Furthermore, its Review of the Principles for the Sound Management of Operational Risk,[14] highlights the importance of the role of disclosure. Principle 11 "Role of Disclosure" states that a bank's public disclosures should allow stakeholders to assess its approach to operational risk management.

The following important observations were also made in relation to the adequacy, implementation of policies, and verification of risk disclosure practices:[15]

- that regarding the adequacy of operational risk disclosures for stakeholders, most noted that there is a dedicated section for operational risk in external reports, which are regularly updated. However, since most banks don't disclose sensitive information relating to control gaps or issues, these disclosures tend to be primarily high-level statements

- that in relation to the disclosure policies that address operational risk disclosures, most banks reported that these are not fully implemented and that the general inference was that most participating banks have in place, or will shortly have in place, a disclosure policy.

- In addition, some banks have yet to implement a process to review and verify operational risk disclosure practices

As well as the recognition of the need for a Pillar 3 disclosure framework which does not conflict with requirements under accounting standards, which are broader in scope, under given circumstances,

[13] "The Committee aims to encourage market discipline by developing a set of disclosure requirements which will allow market participants to assess key pieces of information on the scope of application, capital, risk exposures, risk assessment processes, and hence the capital adequacy of the institution."
See Basel Committee on Banking Supervision, "Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework - Comprehensive Version June 2006 at page 226
http://www.bis.org/publ/bcbs128c.pdf

[14] See Basel Committee on Banking Supervision, Review of the Principles for the Sound Management of Operational Risk 6 October 2014
http://www.bis.org/publ/bcbs292.pdf

[15] see ibid at page 33

banks are required to explain material differences between the accounting or other disclosure, as well as the supervisory basis of disclosure.[16]

From the three pillars, the third pillar, is perhaps that area which requires the greatest level of simplicity and comparability in terms of the need to facilitate comparisons of disclosures across jurisdictions. Not only because of the level of expertise or role of those involved, but also the need to ensure that potential for abuse of such information, as well as information asymmetries are mitigated - and that right signals are conveyed to the market. Information which may or may not have huge systemic consequences. The degree to which such information is accurate would definitely depend on Pillars I and II. It could be argued that each pillar should be accorded the same degree of accuracy or simplicity. However, it would also appear that those processes involving measurements require greater degree of accuracy.

From this perspective, the summary comparison table, common disclosure template, and reconciliation requirement for public disclosures (Basel III leverage ratios) and the considerable efforts which have been dedicated towards facilitating meaningful comparisons across jurisdictions with different accounting frameworks, represent a huge step towards achieving the goals of disclosure, namely: assisting market participants to "assess key pieces of information on the scope of application, capital, risk exposures, risk assessment processes, and hence the capital adequacy of the institution."

Where all efforts have been undertaken to facilitate accuracy, then some stages and processes are better left to address the need for consistency and comparability - particularly in unavoidable circumstances which are attributed to different and inflexible accounting policies and frameworks. Another lesson derived from the implementation of the Basel III leverage ratio is that the goal of simplicity and consistency, associated with the aims and objectives of the leverage ratio has not really been realised and that its implementation has only prompted more complex scenarios and applications in the form of the introduction of jurisdictional supplementary leverage ratios - as well as enhanced supplementary leverage ratios. Such developments whilst being attributed to calibration issues between the capital adequacy and leverage ratio frameworks, have also taken place owing to fears of inaccurate measures - particularly the use of credit conversion factors within the Standardised Approach (SA-CCR) framework to account for off balance sheet exposures, and the need to avoid undercapitalisation with particularly, globally systemically important banking institutions.

[16] "Such explanation does not have to take the form of a line by line reconciliation."
See Basel Committee on Banking Supervision, "Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework - Comprehensive Version June 2006 at page 227

References

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