Basel Committee Proposals for Operational Risk

September 2001 Working Paper

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Development Process

- Dialogue with industry based on September OR paper
- Consider results of QIS 2
- Issue new capital accord proposal 1st Quarter 2002
- Conduct QIS 3 during 3 month comment period
- Issue final new capital accord in 2nd Half 2002
- Implement in 2005

Definition

- Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.

Three Pillar Framework

- Pillar I
  - Capital Requirement
- Pillar II
  - Economic capital allocation subject to supervisory review
  - Sound practice guidance
- Pillar III
  - Public disclosure/market discipline

Pillar I Capital Approaches

- Basic Indicator
- Standardised (business line)
- Advanced Measurement

Basic Indicator Approach

- Capital requirement is fixed percentage, a, of gross income
- a is calculated assuming that OR capital allocation is 12 percent of minimum regulatory capital
- Weighted average a for large banks is 18.3%

Standardised Approach

- Bank's activities divided into 8 business lines
- Capital requirement for each business line is fixed percentage, $ß_i$, of line's gross income
- Total OR capital is simple summation

Determining the ßs

- 12 percent of minimum regulatory capital is distributed across 8 business lines in proportion to OR economic capital allocation
- ßs calculated as business line regulatory capital divided by business line gross income
- Weighted average ßs range from 11 percent for “retail banking” to 20 percent for “trading and sales” (high standard deviations)

Advanced Measurement Approaches

- Based on bank's internal risk measurement system
- Subject to qualitative and quantitative standards
  - Requires use of internal data subject to a soundness standard
- Subject to a floor capital requirement (transitional)
  - 75 percent of Standardised Approach

AMAs currently under Development

- Internal measurement approach similar to PD/LGD/EAD approach for credit risk
- Loss distribution approaches
- Scorecard approaches

Data Collection

- Rely on industry working group to define loss event data matrix
- Loss events are categorized by standardised business lines and event types
- Examples of business lines are corporate finance, “trading and sales” and retail banking
- Examples of event types are internal fraud, external fraud, employment practices, business practices and damage to physical assets.

Risk Mitigation

- Sound management practices
- Internal controls
- Insurance protection

Some Observations

- EL/UL and the uses of internal data
- Data limitations
- Positive incentive structure
  - Advance to more risk sensitive approaches
  - Continue development efforts