Revised Operational Risk Capital Framework

Key Industry Views

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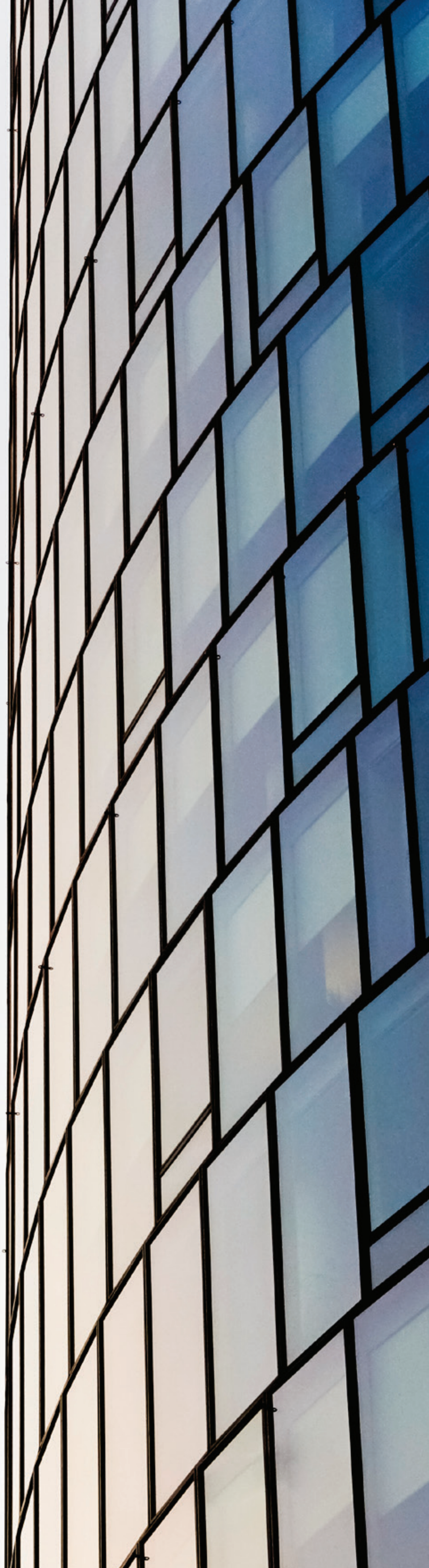

Summary

On 4 March 2016 the Basel Committee on Banking Standards (BCBS) released the long awaited revised consultation paper on operational risk capital . This proposed to scrap internal modelling (under the Advanced Measurement Approach, AMA) and revise all current approaches to, instead, measuring operational risk capital with one Standardised Measurement Approach (SMA). The BCBS has subsequently also published a consultation paper on revised Pillar 3 disclosure requirements , including amendments relating to operational risk. These include revising disclosures to meet the newly proposed SMA, additional disclosures of internal losses, and detailed information relating to the operational risk management framework.

Two weeks following the release of the consultation, KPMG in the UK held a roundtable discussion with senior operational risk representatives from across the industry to debate these new proposals. The roundtable was conducted under the Chatham House Rule. There were thirteen participants across a mix of G-SIBs, larger banks, and smaller UK-focussed firms, with firms currently adopting The Standardised Approach (TSA) and the AMA. The discussions were wide ranging with lots of insights and views shared on the proposals themselves and more broadly regarding the future of operational risk management.

Top 5 Key Themes

1. The new proposals do not capture the full picture in relation to operational risk

There was a consistent view across participants that the new proposals only cover a portion of operational risk management and measurement, and in themselves are unhelpful in improving operational risk across the industry. While the consultation paper is focused on the measurement of pillar 1 operational risk capital, it was suggested that further guidance on good operational risk management practices and the linkage with stress-testing would be helpful to provide the wider context of the BCBS proposals and its links to other components of the operational risk framework. It may also show how, overall, the framework is risk-sensitive – 92% of participants thought the proposal was not risk-sensitive enough on a standalone basis.

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In addition, the consultation paper only mentions that the AMA, in the form it was introduced in 2006, did not meet the BCBS's expectations and therefore removal is warranted. However, it was felt that the paper could have gone into more detail breaking the AMA down and explaining which parts did and did not work, and therefore potentially discussing how the modelling approach could be refined rather than throwing the baby out with the bath water and simply removing it altogether. In general, it was felt a better approach would be to keep some form of internal modelling that is a revised version of the AMA, but that is a simpler, more prescriptive modelling approach that is consistent across jurisdictions.

The proposals for Pillar 1 are much simpler (than AMA) and more detailed disclosure would be required under Pillar 3. Combined, it was felt that these changes do improve comparability across organisations. But Pillar 2 figures and methodologies will continue to remain opaque and particularly incomparable across jurisdictions as local supervisors continue to have very different approaches to Pillar 2 operational risk capital.

2. Capital levels are likely to increase

The BCBS has stated that while the objective of these proposals is not to significantly increase overall capital requirements, the impact of the new framework will vary from bank to bank and may lead to an increase in minimum capital requirements for some banks. Of participating banks, 83% confirmed that they anticipated their Pillar 1 capital requirements would increase due to the SMA, with a quarter of firms thinking the impact would be greater than a 70% rise. Some participants may be slightly better off under Pillar 1 due to more conservative and prescriptive current approach to capital requirements by home supervisors, but the view was that this wouldn't be the case when looking at overall capital levels.

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of participants anticipated their Pillar 1 capital requirements would increase due to the SMA, with a quarter of firms thinking the impact would be greater than a 70% rise.

It was observed that over recent years internal losses have increased more rapidly than banks' capital levels. Since the SMA approach incorporates internal losses (for banks in buckets 2-5) as an element to enhancing risk-sensitivity, capital requirements are likely to increase further given the growing internal losses.

Another impact outlined was that since 10 years' worth of loss data would be required for the SMA (for banks in buckets 2-5), any significant internal loss event taking place would increase capital levels for the following 10 years, despite any efforts by the firm to enhance the control environment, including spending significant sums on remediation.

For smaller banks (in bucket 1) under SMA their capital would not depend on their internal losses. As a result, participants believed the proposed approach could possibly reduce their current Pillar 1 capital levels since the coefficient for the proposed Business Indicator under SMA would be 11% which is lower than the current coefficients for the Basic Indicator Approach (BIA) and TSA approaches of 15% and 12%-18% respectively.

3. Incentivising good operational risk management will be more challenging

Participants believed AMA was and remains a good way to incentivise firms to maintain robust operational risk management since it takes into account internal losses, scenario analysis, and the business environment and internal control factors within a firm – i.e. there is a direct link between improving operational risk management and reducing operational risk capital.

> 77% of participants were concerned that the SMA would not incentivise continual improvements in operational risk management.

Whilst the SMA proposal tries to address the risk-sensitivity aspect, it was felt that under SMA there would be significantly fewer incentives to strengthen operational risk management given that internal loss data would be the only component of the framework that would remain as part of the Pillar 1 capital calculations. As an example, since the calculation uses 10 years of a firm's internal loss data then a one-off significant loss would impact capital levels for the following 10 years, and so there would be reduced incentives for improving risk management within the organisation during this period. Seventy seven percent of participants were concerned that the SMA would not incentivise continual improvements in operational risk management.

Banks' view was that going forward Pillar 2 capital requirements would be the engine for promoting robust operational risk management and maintaining the forward looking element to operational risk measurement. However, the consistency and comparability across the industry in relation to Pillar 2 capital requirements was an area of concern for participants given the variation of approaches adopted by supervisors globally. Ninety percent of participants could not foresee a globally consistent approach being applied by supervisors in relation to Pillar 2 operational risk capital – conversely 60% thought a consistent approach would be applied for Pillar 1 given the new requirement.

Participants believed that the other operational risk framework tools omitted from this proposal such as external loss data and scenario analysis have proved to be very informative and useful elements for operational risk management within firms. They have engaged the business as they help to show what could potentially happen and what they, as the business, should be aware of and looking out for. They also feed into the banks internal stress-testing processes.

Firms should seek to ensure they have robust systems and processes in place, embedded within the business, for capturing internal loss data, since this will be a critical component of the Pillar 1 capital calculation under the SMA. It is therefore important for firms to have a risk culture within them of proactive raising and reporting of incidents and events in a timely manner.

Participants were concerned about how to encourage this without strong capital incentives and with recourse being severe, particularly with the implementation of the Senior Manager and Certification Regimes (SMCR) in the UK making individuals more accountable. The view was that generally this proactive reporting is encouraged due to the threat of potential consequences being more severe if the issue is discovered at a later stage and nothing had previously been escalated. However, participants also felt that SMCR may, in itself, also incentivise good risk management due to Senior Managers having to demonstrate that they have taken 'reasonable steps'.

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4. Further guidance is required in the detail of the proposals

Participants felt that the proposals lacked a necessary level of granularity in some areas, both in terms of the Pillar 1 calculation (what is or isn't included in the internal loss data, what is or isn't included in the Business Indicator calculation) and the Pillar 3 disclosures (what should or shouldn't be captured and disclosed).

Some examples of areas requiring further guidance included:

- The recognition, treatment and timing of provisions for operational risk contingencies
- How should boundary events be treated? Will they be double counted?
- How should litigation events and fines be incorporated?
- How do different detailed elements of the financial statements fit into the different Business Indicator components?
- How should derivatives be treated and what are the implication of and on hedge accounting?
- Which trading losses should be captured as operational risk losses?
- Will businesses that are being divested need to be incorporated into the calculations and disclosures?
- Is the internal loss threshold strictly €10,000 or will it be 10,000 in local currency? This would have a significant implication when looking back at 10 years' worth of historic losses due to fluctuations in foreign exchange rates, without significantly improving transparency or stability.

75%

of participants thought their systems and processes would largely capture the data that would meet the new requirements, and their infrastructure would not require significant change.

If more detailed guidance is not provided then participants felt there is a risk that firms will have different interpretations and use different approaches for what is and isn't included, thereby reducing the comparability and transparency sought by the BCBS.

However, despite these open questions regarding the data requirements, 75% of participants thought their systems and processes would largely capture the data that would meet the new requirements, and their infrastructure would not require significant change.

5. The Pillar 3 disclosure requirements are welcomed

38% thinking the industry should have access to this level of data.

77% of participants thought the Pillar 3 changes will help improve transparency and comparability across banks

Participants thought the operational risk changes included within the Pillar 3 proposals were positive with a view that these would help educate individuals within firms as well as the broader industry on operational risk, and should be helpful to external investors and the market, with 38% thinking the industry should have access to this level of data.

Also, 77% of participants thought the Pillar 3 changes will help improve transparency and comparability across banks, at least from a Pillar 1 perspective.

Is there a better approach?

The BCBS consultation has asked firms to comment on the current proposals. They also said they may consider alternative approaches to ensure a stable and risk-sensitive framework, so firms are encouraged to offer alternative approaches if they think these would be better.

This was seen somewhat as a surprise to firms since the BCBS has been consulting and drafting proposals for over 2 years (the previous consultation paper was released in October 2014 prior to this revised paper) and it has been informed by local regulators and firms contributing to Quantitative Impact Studies (QIS).

Some alternative suggestions discussed during our roundtable event were to:

- Maintain an internal modelling approach, but be more prescriptive about how to apply this approach, for example standardising data collection and providing stricter guidance on the use of the 4 data elements.
- Ensure international approaches to supervision and regulatory expectations of operational risk measurement and management (under all 3 pillars of the capital framework) were aligned through BCBS guidance or introduced global benchmarking.
- Look at operational risk measurement and management holistically rather than piecemeal (i.e. not separating out pillar 1, 2 and 3 as well as other guidance such as the BCBS Principles for the Sound Management of Operational Risk), ensuring there remains strong incentives for good operational risk management, sufficient capital for helping to mitigate large, unexpected tail events, as well as striking the balance between risk-sensitivity, complexity, and comparability.

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