BCBS Consultation on the Standardised Measurement Approach for operational risk

May 2016

The Basel Committee on Banking Supervision (BCBS) has released a consultative document on the Standardised Measurement Approach (SMA) for operational risk calculation.

This document supersedes a consultation undertaken in October 2014, in which BCBS had proposed replacing the Basic Indicator Approach (BIA) and the Standardised Approach (TSA) with a Revised Standardised Approach (SA). At that time, no changes to the Advanced Measurement Approach (AMA) had been put forward.

In the new consultation, however, the BCBS proposes replacing the BIA, TSA and AMA with the new SMA.

One week after the release of this consultative document, the BCBS also published a consultation on enhancements to the Pillar 3 disclosure requirements. We include relevant information in this publication regarding the amendments relating to operational risk disclosures in this separate consultation.

Responses to the consultative document are due on or before 3 June 2016. The BCBS is expected to provide further information about the implementation timeline within 2016.

Key proposed changes

Key changes arising from this consultative document, including proposed Pillar 3 disclosure requirements, are:

1. The withdrawal of the AMA, and replacement of the Basel II Operational Risk capital calculation approaches to operational risk with a single SMA
2. Revisions to the Business Indicator (BI) approach in response to the October 2014 consultation
3. The introduction of risk sensitivity to the calculation of operational risk capital through the use of the Internal Loss Multiplier (ILM), which provides some incentive for banks to improve their operational risk management
4. Revisions to Pillar 3 disclosure requirements to meet the newly proposed SMA, additional disclosures of internal losses, and more detailed information relating to banks' operational risk management framework.

The evolution of the Basel Committee's operational risk approaches

In 2004, the BCBS recommended that operational risk be defined as an independent risk category that must be backed by regulatory capital. This resulted in three approaches to calculate operational risk capital under Basel II. In March 2016, the BCBS proposed replacing Basel II's three approaches with one single approach, the SMA.

Significant policy changes or consultations regarding operational risk capital calculation and Pillar 3 disclosure to date

JUN 2004
Basel II

Introduced three approaches to measure operational risk capital

BIA
Based on 15% gross income

TSA
Based on 15-18% gross income per business line

AMA
Based on internal statistical models

NOTE: The three approaches under Basel II introduce *increasing levels of sophistication and risk sensitivity.* Internationally active banks and banks with significant operational risk exposures were expected to use a more sophisticated approach.

OCT 2014
BCBS consultative document

Proposed to replace BIA and TSA with SA. No changes to AMA.

Superseded

SA
Based on:
- The BI
- Five bucket structure with regulatory coefficients of 10-30%

AMA

MAR 2016
BCBS consultative document *
(revision to Oct 2014 document)

Proposed to replace BIA, TSA and AMA with SMA.

SMA
Based on:
- The BI (revised from Oct 2014)
- Five bucket structure with a BI component range of 0.11-0.29
- Bank-specific loss data (depending on bucket)

NOTE: Irrespective of whether the bank applies BIA, TSA or AMA, the BCBS continues to encourage all banks to comply with the *Principles for the Sound Management of Operational Risk* (2011), as is currently done.

* In addition, the BCBS also published a consultative document in March 2016 on revised Pillar 3 disclosure requirements, including amendments relating to operational risk disclosures.

Comparing Basel II and the SMA

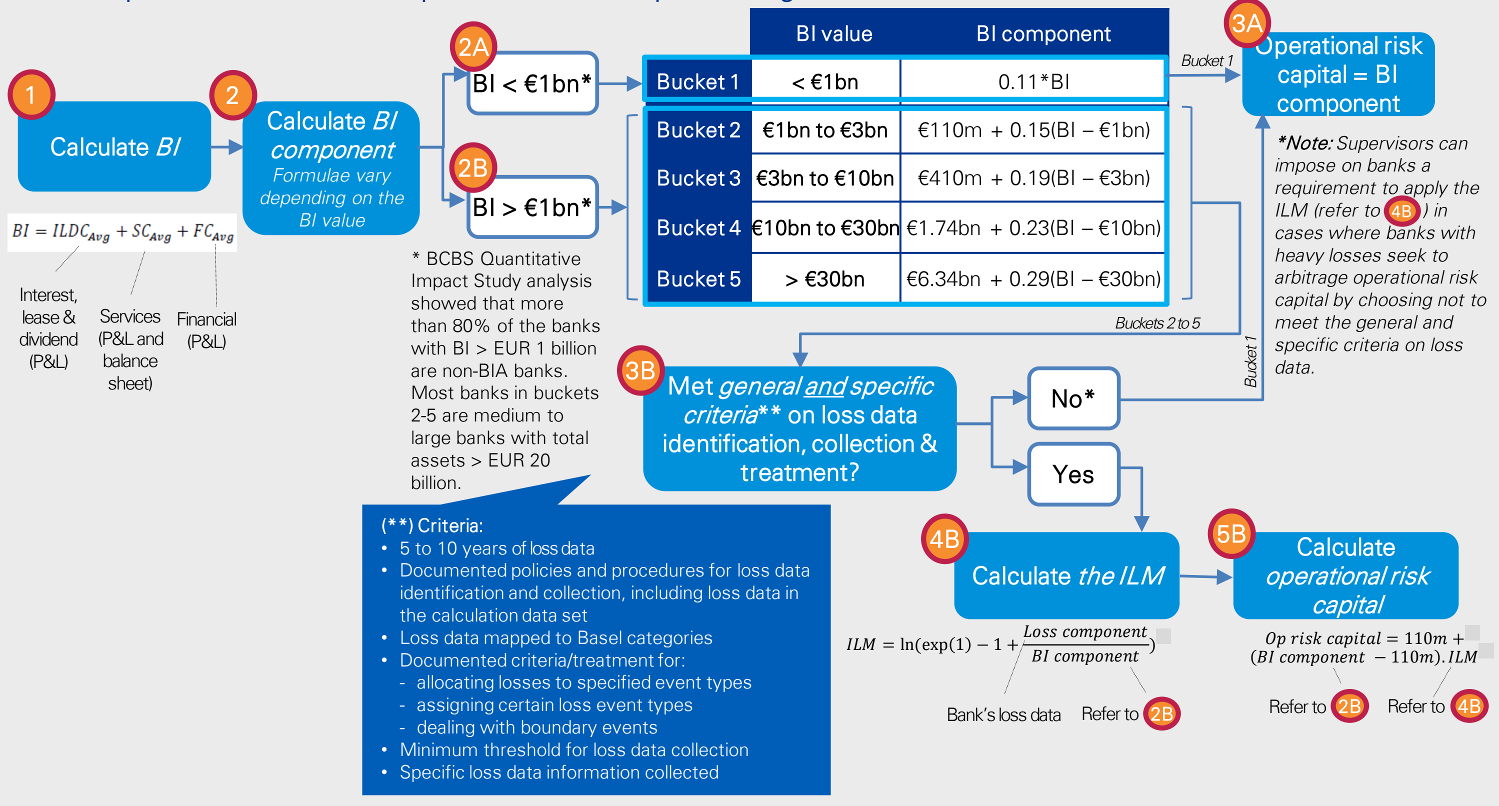
The SMA combines the main elements of the SA (which was consulted on in October 2014) with a bank's internal loss experience, which was a key component of the AMA. However, the current consultation is less explicit in terms of risk management aspects:

		BIA	TSA	AMA	Proposed SA (Oct 2014)	Proposed SMA (Mar 2016)
	Qualifying criteria/ Supervisory approval	✗	✓	✓	✗	Implied – not explicitly stated
Risk management	Qualitative standards	✗	✓	✓	✓ (under Pillar 2)	Not stated
Risk management	Principles for the Sound Management of Operational Risk (2011)	Encouraged	✓	✓	✓	Encouraged
Capital calculation	Quantitative standards	✗	✓	✓	✗	✓ (internal loss data only)
Capital calculation	Calculation	Factor-based	Factor-based on a scale	Model-driven	BI	BI component, ILM
Capital calculation	Inputs	Gross income	Gross income of business line	• Internal loss data • External loss data • Scenarios • Business environment & internal control factors	• BI made up of P&L and balance sheet items	• BI made up of P&L and balance sheet items • Internal loss data
Capital calculation	Application	Aggregate	By business line	By business line	Aggregate	Aggregate

Calculating operational risk capital using the SMA

The SMA combines the BI – a simple financial statement proxy of operational risk exposure – with bank-specific loss data. The introduction of the internal loss experience into the SMA framework not only enhances the risk sensitivity, but also provides incentive for banks to improve operational risk management.

Overall process to calculate operational risk capital using the SMA



The key impacts of the SMA on banks

Banks will welcome greater certainty in an area that has been under review for many years, notably the revisions to the BI approach in response to comments on the October 2014 consultative document, and the recognition of bank-specific loss data. However, some concerns are likely to remain:

Capital	• Analysis of the 2014 proposal showed that some global banks could face **increases of up to 70% of their Pillar 1 operational risk capital charges**. The 2016 proposal should have a smaller impact, but this **could still be significant for some banks**. • The overall impact will also depend on how the proposed new Pillar 1 approach interfaces with Pillar 2 capital requirements – banks that can demonstrate good internal modelling and strong operational risk systems and controls could potentially gain a partial offset to higher Pillar 1 requirements. • Banks will need to **revise their systems and processes to deliver the required calculations**.
Internal loss data	• The data requirements for calculating internal loss experience and the proposed disclosure requirements will impose an **additional burden** on some banks. • Banks not currently using the AMA will have to **put the necessary systems and processes in place** to collect, analyse and report the required data.
Incentives for good operational risk management practices	• The introduction of a loss data experience will provide some **regulatory incentive for banks to reduce their operational risk losses**. However, this element of risk sensitivity is limited to past losses, and does not include other key elements of the AMA, namely external data, scenario analysis, and the business environment and internal control factors data. • The Pillar 2 capital framework is used as a tool by some regulators to encourage **enhanced risk management** across banks. However, it remains to be seen how this will be applied by supervisors and how consistently this will be used globally.
Disclosures	• The enhanced Pillar 3 disclosure requirements will require banks to detail how they manage their operational risks as well as their loss history: (i) BI value for the last three years; (ii) losses for the last three years (including the number of losses and total amount of losses > EUR 1 million, and the total of the five largest losses); and (iii) historical losses used for SMA calculation split over the last 10 years (total amount, and total amount > EUR 1 million). • Banks will need to **revise their systems and processes to deliver the required disclosures**.

What banks need to do now

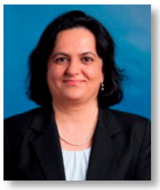
Authorised institutions (AIs) should consider assessing impacted areas to ensure they are well-prepared for the expected changes arising from the proposed SMA requirements :

- **Operational impacts –** Assess the impacts on the AI's existing systems and processes, i.e. new information required as part of Pillar 3 reporting, data quality under the existing internal data loss collection process, and data required as part of the operational risk capital calculation process.
- **Capital impacts** – Assess the impacts on the AI's existing capital.

"Considering the potential impacts under the proposed SMA, banks should not delay taking action to enhance their existing operational risk systems and processes."

– Fiona Teh, Associate Director, Financial Risk Management, KPMG China

Contact us



Jyoti Vazirani
Principal, Head of Financial Risk Management
KPMG China
T: +852 2685 7331
E: jyoti.vazirani@kpmg.com

Fiona Teh
Associate Director, Financial Risk Management
KPMG China
T: +852 2685 7658
E: fiona.teh@kpmg.com

kpmg.com/cn