



Revision of OpRisk Capital Charges

Summary

The Basel Committee for Banking Supervision has published a long awaited consultative paper proposing a new way to calculate capital for OpRisk other than AMA. The proposal is well researched and does more justice to the actual OpRisk exposure than the previous approaches. This OpRisk Update lists the major differences and remaining issues.

Dear reader,

Below you will find a brief summary of the proposed changes¹, highlighting the proposal itself, and the major questions still under discussion. It is worth noting the main reason for proposing these changes. Paraphrasing slightly, the committee found that the existing simple methods were undercalibrated and that AMA was typically benchmarked against these undercalibrated outcomes.

The major changes are the following:

Existing Method	New Proposal	Rationale
Three simple approaches, BIA, TSA and ASA.	Only one simple revised Standardised Approach (SA)	Comparability among institutions, simple to implement
Banks can only adopt TSA and ASA if they meet qualifying criteria of sound OpRisk management	One size fits all and no qualifying criteria.	All banks are expected to meet the qualifying criteria.
Gross Income (GI) is used as the proxy indicator for OpRisk exposure.	Using a Business Indicator (BI) comprising an “ <i>interest component</i> ”, a “ <i>services component</i> ”, and a “ <i>financial component</i> ”.	BI includes items sensitive to operational risk that are omitted or netted from the GI definition.
$GI = \text{Interest Income} - \text{Interest Expense} + \text{Fee Income} - \text{Fee Expense} + \text{Other Operating Income} + \text{Net P\&L on Trading Book} + \text{Dividend Income}$	$BI = \text{ABS}(\text{Interest Income} - \text{Interest Expense}) + \text{Fee Income} + \text{Fee Expense} + \text{Other Operating Income} + \text{Other Operating Expense} + \text{ABS}(\text{Net P\&L on Trading Book}) + \text{ABS}(\text{Net P\&L on Banking Book})$	<ul style="list-style-type: none"> - Absolute values prevent counterintuitive results - increasing the weight of high OpRisk components
α and β applied to GI are fixed and linear	A five-tier layered rate applied to BI, bucketed with increasing from 10% to 30%.	OpRisk capital should increase non-linearly with the bank’s size.
Replacing GI by an asset-based proxy (= loan and advances multiplied by 0.035) in two business lines (retail and commercial banking) for banks with extremely high net interest margins (NIM)	a) Multiplying the interest component with a normalisation ratio for very high or very low NIMs b) apply a floor and ceiling to the interest component	Normalising the interest component when it is outside a collar. Method to be decided.
$K_{TSA} = [\sum_{\text{years}1-3} \sum_{BL=1-6} (GI_{BL} \cdot \beta_{BL})]/3$	$K_{SA} = [\sum_{\text{years}1-3} \sum_{j=1-5} (BI_j \cdot \alpha_j)]/3$	Five buckets instead of 6 business lines

¹The full consultative paper is available at <http://www.bis.org/publ/bcbs291.htm>

We shall contrast it with the existing methodologies as published in June 2006. <http://www.bis.org/publ/bcbs128.htm>



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Questions by the Committee	GRAS remark
Q1. Are there any other weaknesses in the existing set of simple approaches that should be addressed by the Committee?	The new proposal still does not take into account any OpRisk <i>management</i> . See also Q4.
Q2. Does a single standardised approach strike an appropriate balance across the Committee's objectives of simplicity, comparability and risk sensitivity?	Somewhat more risk sensitive than BIA, TSA, and ASA.
Q3. Are there any further improvements to the BI that should be considered by the Committee?	BI should remain as simple as possible. Using absolute numbers is a great improvement. At the risk of introducing pro-cyclicality Net P&L might be replaced by the sum "Profit + ABS(Loss)".
Q4. What additional work should the Committee perform to assess the appropriateness of operational risk capital levels?	The OpRisk charge should take into account the strength of the 2 nd and 3 rd line of defence relative to total operating income. Such a factor (e.g. the fraction of expenses for Audit / Compliance / BCM / OpRisk / Information Security).
Q5. Are there any other considerations that should be taken into account when establishing the size-based buckets and coefficients? How many BI buckets would be practical for implementation while adequately capturing differences in operational risk profiles?	Buckets will always introduce 'cliffs'. A continuous function should be considered.
Q6. Are there any other considerations that should be taken into account when replacing business lines with size-based buckets?	Excellent change.
Q7. Could there be any implementation challenges in the proposed layered approach?	No material obstacles
Q8. Do the issues of high interest margin and highly fee specialised businesses in some jurisdictions need special attention by the Committee? What could be other approaches to addressing these issues?	A "complexity charge" factored into the buckets would take care of specific income anomalies.
Q9. What would be the most effective approach to promoting rigorous operational risk management at banks, particularly large banks?	Under supervisory discretion, an add on charge (multiplier) using qualifying criteria is warranted.

What is interesting to note is that the new elements have been calibrated using a quantitative model known as the Operational risk Capital-at-Risk (OpCaR) model uses. It is based on one of the four AMA elements, the bank-internal loss data. It is useful to see how the committee models this data since it provides welcome pointers towards a baseline approach for AMA.