BASEL COMMITTEE'S NEW STANDARDISED MEASUREMENT APPROACH: BEST OF BOTH WORLDS?

Posted on March 10, 2016

Categories: Insights, Publications

On March 4, 2016, the Basel Committee on Banking Supervision (the "Basel Committee") published a consultative document setting out its proposed revisions to the operational risk capital framework. This is the second round of consultations aimed at an improved approach to operational risk, with an earlier iteration of proposed changes first published in October of 2014.The new Standardised Measurement Approach ("SMA") is intended to address weaknesses in the existing framework while advancing the broader goal of balancing simplicity, comparability and risk sensitivity.

The Current Framework

Banks are required to maintain capital as a cushion to protect against various forms of loss. Operational risk captures the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.

The current operational risk framework adopted for banks in Canada is set out in the Office of the Superintendent of Financial Institution's ("OSFI") Capital Adequacy Requirements Guideline. The framework, based on Basel II, contains three methods for calculating the required capital charge for a bank's operational risk:

- Basic Indicator Approach: A bank must hold capital for operational risk equal to the three year average of a fixed percentage (currently 15%) of positive annual gross income.
- Standardized Approach: A bank's activities are divided into eight business lines and the capital charge for each is gross income times an assigned factor (currently ranging from 12-18%). The total capital charge is the three year average of the sum of capital charges across each business line in each year.
- Advanced Measurement Approaches ("AMA"): The capital requirement is determined by the risk measure internally generated by the bank's risk measurement system using certain qualitative and quantitative criteria. Use of this approach is subject to supervisory approval.

These approaches represent a continuum towards increasing sophistication and risk sensitivity, and banks are encouraged to move along the spectrum in accordance with the level of sophistication of their internal operational risk measurement and practices.

Proposed Changes

At a high level, the revised methodology combines a financial statement-based measure of operational risk (the "Business Indicator" or "BI") with an individual bank's internal past operational loss data (the "Loss Component"). It has been designed to suit all banks, irrespective of their size and risk profile.

BI is calculated using financial profit and loss ("P&L") components and is then calibrated using data gathered from the Basel Committee's quantitative impact study ("QIS"). The calibrated BI Component reflects the operational loss exposure of an average QIS bank of a given BI size.

BI offers the advantage of being comparable across banks. However, the risk profile of medium to large banks cannot be comprehensively captured by an approach based on financial statement data alone. Banks with similar BI values may well have significant differences in their operational risk profiles.

As a result, the Basel Committee introduced the Loss Component into the measure to increase risk sensitivity. The Loss Component also acts as an incentive for banks to improve their operational risk management thereby lowering their respective operational risk regulatory capital charge. However, the Basel Committee's recommendation is that this Loss Component only be used for medium to large banks as smaller banks (€0 to €1 billion) may not have the required information readily available.

Once implemented, the SMA will replace the existing approaches for calculating the capital charge for operational risk. It will apply to internationally active banks on a consolidated basis with OSFI retaining discretion to apply the framework to non-internationally active institutions.

Impact of Proposed Changes

The overall objective of the new methodology is not to significantly increase capital requirements, but it is likely that the minimum capital requirements will increase for at least some banks. This in turn may increase such banks' funding costs and, ultimately, also increase the cost of borrowing for the customer.

However, preliminary views suggest that the new SMA may contribute to a more simplified operational risk management system that will allow for greater comparative accuracy across institutions and will also help to ensure that appropriate buffers are in place to withstand negative economic fluctuation.

The Basel Committee encourages comments and constructive dialogue with respect to the proposed new approach. Comments can be submitted until June 3, 2016, using the online form. Based on comments and the final results of the QIS, the Basel Committee will adjust, calibrate and publish the final standard with sufficient time to allow for implementation. It is anticipated that further details with respect to the implementation timeline will be made available during the course of 2016.

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A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.