

Basel III: Finalizing Post-Crisis Reforms

KAPLAN SCHWESER

The Standardized Approach

- The **standardized approach** for measuring operational risk is a combination of (1) the business indicator (BI), (2) the business indicator component (BIC), which is the product of a regulatory marginal coefficient and BI, and (3) operational loss data specific to an individual bank [i.e., internal loss multiplier (ILM)].
- For the purposes of calculating the standardized approach, banks (based on their size for the BI component) are divided into three buckets.

BI Buckets and Internal Loss Multiplier

IESII

Bucket	BI Range	BIC
1	€0 billion–€1 billion	$0.12 \times \text{BI}$
2	€1 billion–€30 billion	$0.15 \times \text{BI}$
3	€30 billion– $+\infty$	$0.18 \times \text{BI}$

$$\text{Internal Loss Multiplier} = \ln \left[e^1 - 1 + \left(\frac{\text{Loss Component}}{\text{BIC}} \right)^{0.8} \right]$$

© Kaplan, Inc.

2

Standardized Approach Capital Requirement Calculation

The standardized approach is used to determine the operational risk capital requirement and is calculated as follows:

- For BI bucket 1 banks:
 - Operational risk capital = BIC
- For BI bucket 2 and bucket 3 banks:
 - Operational risk capital = BIC × ILM

© Kaplan, Inc.

3

Standardized Approach vs. Earlier Approaches

- The older advanced measurement approach (AMA) allowed banks to use a vast range of models that were inherently more flexible for individual banks but prevented valuable comparisons among banks.
- For this reason, the standardized approach was created as a non-model-based approach used to assess operational risk using both financial statement measures and loss data unique to individual banks.

Identification, Collection, and Treatment of Operational Loss Data

- For identifying, collecting, and accounting for operational loss data, the Basel Committee has outlined several general and specific criteria that should be used.
- Key general criteria include processes and procedures, documentation needed, thresholds for capturing losses, and appropriate periods.
- Specific criteria include how to calculate gross losses (what is included versus what is excluded) and key dates used to capture the losses.

GARP 2020 Op Risk Q10 (also 2019 Q10)

An operational risk manager is asked to report a bank's operational risk capital under the Standardized Measurement Approach (SMA) proposed by the Basel Committee in March 2016. The Treasury Department produces the following data for the bank, calculated according to the SMA guidelines:

- Business indicator: EUR 1,200 million
- Internal loss multiplier: 1

Bucket	BI Range	BI Component
1	EUR 0 – EUR 1 billion	$0.12 \times \text{BI}$
2	EUR 1 – EUR 30 billion	$\text{EUR } 120\text{m} + 0.15 (\text{BI} - \text{EUR } 1 \text{ billion})$
3	EUR 30 billion to infinity	$\text{EUR } 4.47 \text{ billion} + 0.18 (\text{BI} - 30 \text{ billion})$

What is the correct operational risk capital that the bank should report under the SMA?

- A. EUR 120 million.**
- B. EUR 150 million.**
- C. EUR 158 million.**
- D. EUR 180 million.**

© Kaplan, Inc.

6

GARP 2020 Op Risk Q10—Answer

- Business indicator value of EUR 1,200 m
- $(1,000 \text{ m} \times 0.12) + (200\text{m} \times 0.15) = \text{EUR } 150 \text{ m}$

© Kaplan, Inc.

7

GARP 2020 Op Risk Q39

A bank owned several retail branch buildings that were destroyed in a hurricane. A financial analyst at the bank wants to determine the correct costs to include in reporting this loss in its operational risk event database. Which of the following costs associated with this loss should be included in the operational loss report?

- A. Costs of insurance premiums paid to insure the buildings before the storm took place**
- B. A provision for the estimated opportunity costs of lost banking business at the affected branches**
- C. Legal costs paid to obtain construction permits to rebuild the destroyed branch buildings**
- D. Costs of a program to train branch managers on ways to prepare buildings to mitigate potential damage from future hurricanes**

GARP 2020 Op Risk Q39—Answer

Most costs associated with an operational loss should be included, however, there are several categories of costs which should not be (such as opportunity costs, forgone revenue, and costs related to risk management and control enhancements implemented to prevent future operational losses.) Known legal costs incurred as a result of the loss should be included as part of the report.

A is incorrect because costs of insurance are paid in advance. Insurance is purchased to protect the firm against potential operational losses but at the time insurance is purchased, the potentially insurable event (the hurricane) has not happened yet. Therefore, the insurance costs should not be included in the loss report.

B is incorrect because the guidelines specifically prohibit provisions for opportunity costs, i.e. the cost of lost business due to the operational loss event.

D is incorrect because “provisions should not include costs, such as retraining or relocating continuing staff” and should not include “costs related to risk management and control enhancements implemented to prevent future operational losses”.