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POINT OF VIEW

Operational Risk:

Transition to the New Standardized Approach and Strengthening Loss Data Management Practices

FOREWORD

Join us in our 'Uniqus' Financial Risk Management (FRM) Insights Series' where we leverage our expertise to delve into various risk management practices in-depth and concisely. This series is designed for risk management professionals and senior management officers, providing detailed explanations, practical examples, and our expert perspective.

This inaugural publication focuses on 'Operational Risk: Transition to the New Standardized Approach and Strengthening Loss Data Management Practices.' After an extended period of relative stability in operational risk frameworks, the banking sector is now poised for transformative change. The New Standardized Approach supersedes the outdated Basic Indicator Approach (BIA) and Standardized Approach (TSA), marking a significant shift in calculating capital for operational risk.

But why is this change happening now? The answer lies at the confluence of several key factors. The financial landscape has undergone significant transformations since the 2008 global financial crisis. Advances in digital banking, fintech innovations, and cyber threats have introduced new operational risk dimensions not fully captured by previous frameworks. Regulatory expectations have also evolved, emphasizing data integrity, transparency, and accountability.

The New Standardized Approach aligns with this shift, emphasizing granular loss data and business indicator components. This risk-sensitive approach considers operational losses incurred by institutions over the past 3/5/10 years.

This publication explores the key aspects of this transition, providing a comprehensive view of the challenges and opportunities it presents. The New Standardized Approach demands that institutions reexamine their operational risk frameworks, particularly in data collection, validation, and reporting.

At the heart of this transformation lies the need to enhance loss data management practices—a challenge requiring technological innovation and cultural change within organizations. As we navigate this shift, it's essential to recognize that operational risk is not merely a compliance exercise but a strategic driver of long-term stability and growth.

Effective loss data management is not just about meeting regulatory requirements; it's about building a foundation of trust, transparency, and accountability. By leveraging innovative technology, institutions can transform operational risk data into actionable insights, driving better decision-making and fostering a proactive risk culture.

Thank you.

Yours faithfully

For Uniqus Consultech Inc.

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SETTING THE CONTEXT

The advantages of adopting the New Standardized approach

Background

The Basel Committee on Banking Supervision (BCBS) introduced the standardized approach for operational risk as part of the Basel III reforms to enhance operational risk management frameworks and make it more risk sensitive. These guidelines apply to internationally active banks and replace all existing approaches, including the Basic Indicator Approach (BIA), the Standardized Approach (SA), and the Advanced Measurement Approaches (AMA).

The new standardized approach for operational risk calculation integrates a risk-sensitive framework that combines a Business Indicator Component (BIC) with an Internal Loss Multiplier (ILM). The ILM reflects a bank's historical loss experience and, when appropriately managed, can result in capital efficiencies. However, banks must maintain high-quality operational risk loss data for a minimum period of five years and implement a robust framework for loss data collection and governance.

Additionally, to reinforce sound management of operational risk and resilience in the banking industry, BCBS has emphasized the importance of strong internal controls, operational resilience planning, and comprehensive loss data management practices. These measures aim to minimize operational disruptions and ensure banks' ability to withstand and recover from adverse operational risk events.

Key advantages of Basel III SA

01 Risk sensitive approach which uses the entity's own loss experience

02 Strong incentives to strengthen internal controls

03 Freed up capital may be used to generate higher yields

04 Better suited for Banks with strong Loss data management

The revised Standardized Approach (SA) addresses BIA's **shortcomings,** which often over- or underestimate capital charges. BIA was found to underestimate capital needs in stressed periods and for large, diversified financial institutions (FIs), while also **overburdening smaller FIs with excessive capital requirements.** For Banks and Financial Institutions, *SA provides capital relief, ensuring requirements are more proportionate to their size and income levels.*

Comparison of Basic Indicator Approach (BIA) vs. Standardized Approach (SA)

Capital & Risk Computation Methodology

Approach	Basic Indicator Approach (BIA)	Standardized Approach (SA)
Basis of Calculation	Gross income as a proxy for risk exposure	Business indicators (e.g., interest income, expenses) and historical loss data
Granularity	Broad and less risk-sensitive	More granular and risk-sensitive
Capital Formula	Fixed percentage of gross income (15%)	Business Indicator Component (BIC) multiplied by Internal Loss Multiplier (ILM)
Historical Loss Data	Not explicitly incorporated	Explicitly incorporated through ILM
Scenario Analysis	Not mandatory	Mandatory for stress testing and capital computation

Data Requirement & Governance

Approach	Basic Indicator Approach (BIA)	Standardized Approach (SA)
Data Collection	Limited focus on loss data collection	Enhanced focus on detailed loss data collection and reporting
Reporting	High-level reporting of operational risk	Granular reporting of risk incidents, losses, and near-misses
Data Quality	Minimal emphasis on data quality	Strong emphasis on data accuracy and completeness
Risk Governance	Basic governance frameworks	Strengthened governance with clear accountability
Board Oversight	Limited involvement	Active involvement in risk oversight and strategy
Internal Audit	Periodic audits with limited scope	Regular and comprehensive audits focusing on risk management
Risk Governance	Basic governance frameworks	Strengthened governance with clear accountability

Key Takeaways from the Comparison

Enhanced Risk Sensitivity: The new framework introduces a more risk-sensitive approach to operational risk computation.

Greater Emphasis on Data: Institutions must now focus on robust data collection, quality, and reporting.

Stronger Governance: The new framework emphasizes accountability and active board oversight.

Focus on Emerging Risks: Cyber risk, third-party risk, and climate risk are now integral to operational risk management

Implementation Timeline:

Basel III reforms have been implemented to varying degrees across the globe, with significant progress among BCBS member jurisdictions. As of September 2024, over two-thirds of these jurisdictions have published final rules covering all Basel III elements, with standards already in force in more than a third. However, from an operational risk standpoint, banks continue to face challenges related to loss data availability, particularly impacting the use of the Internal Loss Multiplier (ILM), which many are defaulting to 1 due to data limitations.

Basel III SA will replace all the existing methods

The main components are a **Business Indicator (BI)**, also a measure of an FI's income, and a **Loss Component (LC)**, from which an **Internal Loss Multiplier (ILM)** is derived. The **Business Indicator Component (BIC)** is obtained by multiplying the BI with the coefficient. The minimum operational risk capital requirement is the **product of the BIC and the ILM**.

a) Business Indicator (BI) BI = ILDC+SC+FC

Where:

$$\mathrm{ILDC} = \mathrm{Min}\ (\bar{}(Abs[Interest\ Income - Interest\ expense)];\ 2.25\%\ {*}\bar{}(Interest\ Earning\ Assets)) + \bar{}(Dividend\ income)$$

$$\mathrm{SC} = \mathrm{Max}\ (\bar{}(Other\ operating\ income;\ Other\ operating\ expense)) + \mathrm{Maximum}\ (\bar{}(Fee\ income;\ Fee\ expense))$$

$$\mathrm{FC} = \bar{}(Abs\ (Net\ P\&L\ Trading\ book)) + \bar{}(Abs(Net\ P\&L\ Banking\ book))$$

b) BIC = BI * Marginal Coefficient

To calculate the BIC, the BI is allocated to three buckets and the marginal coefficient applied, as shown in the table below.

Buckets	BI Range (in $ Bn USD)	BI Marginal Coefficients (αi)
1	< $1 bn	12%
2	$ 1 bn < BI ≤ $30 bn	15%
3	>$30 bn	18%

c) Loss Component

The LC is defined as 15 times the average annual operational risk losses over the previous 10 years (with a minimum of 5 years during the transition to the SA).

$$ILM = ln\{exp(1) - 1 + [LC/BIC]\text{^}0.8\}$$

d) Operational Risk Capital (ORC) = BIC * ILM

- Entities that do not meet the **five years of high-quality loss data criteria** shall be required to hold ORC at a minimum equal to the BIC
- Loss data is relevant when clearly linked to the entity's current business activities, risk management procedures, and technological processes. Therefore, for the purposes of establishing the data as **high quality,** clear mapping, and sufficient documentation should be maintained. Further, the same must be **validated independently** before use in ILM computation

Illustration: Basic Indicator Approach (BIA) vs. Standardised Approach (SA)

Bank Profile: Mid-sized Bank

- Gross income for the last three years: Year 1: $ 1 bn USD ., Year 2 : $1.2 bn USD , Year 3: $1.5 bn USD Average Income : **$1.23** bn USD Business indicators: details in the table below: **Amt. In Bn USD**

Interest, Lease and Dividend Component (ILDC)

Year	Int. Inc.(a)	Int. Exp (b)	Abs (a)-(b)
Year 1	1.7	1.1	0.6
Year 2	2.1	1.4	0.7
Year 3	2.5	1.7	0.8

Service Component (SC)

Year	Fee & Comm.	Other Operating income	Total
Year 1	0.15	0.10	0.26
Year 2	0.16	0.12	0.28
Year 3	0.18	0.14	0.32

Financial Component (FC)

Year	Net P&L Trad. Book	Net P&L Bank. Book	Total
Year 1	0.14	0.11	0.25
Year 2	0.16	0.12	0.28
Year 3	0.18	0.14	0.32

ILDC= $ 0.7 bn USD, SC= $0.28 bn USD, FC= $0.28 bn USD Average of three years.

BI = ILDC+SC+FC= $ 0.7 bn USD + $0.28 bn USD+ $ 0.28 bn USD = $ 1.27 bn USD.

- Historical operational losses: Year 1: $ 0.1 bn USD Year 2: $ 0.05 bn USD crore Year 3: $ 0.07 bn USD Year 4: $ 0.03 USD crore Year 5: $ 0.01 bn USD over the last 5 years. Average Annual loss : $0.06 bn USD

$$ILM = ln\{exp(1) - 1 + [0.06/0.19]^{\wedge}0.8\}$$

$$\text{ILM} = 0.74$$

Banks with significant historical operational losses may see an increase in capital requirements due to higher ILM. In absence of historical Losses ILM will be 1.

Under Basic Indicator Approach – BIA

Formula: Capital = 15% of average gross income over the last 3 years.

Calculation:

- Average gross income = : **$1.23** bn USD.
- Capital = 15% × : **$1.23** bn USD = **$0.185** bn USD.

Under Standardized Approach - SA

Formula: Capital = Business Indicator Component (BIC) × Internal Loss Multiplier (ILM).

Steps:

a) Calculate BIC: BIC = 15% of $ 1.27 bn USD = **$ 0.19 bn USD.**

b) Calculate ILM: ILM = 0.74 (based on historical losses and risk profile).

c) Compute Capital: Capital = BIC × ILM = $ 0.19 bn× 0.74 **= $0.14 bn USD.**

Comparison of Operational Risk Capital Under BIA Vs.SA

(BIA): $0.185 bn USD

(SA): $0.14 bn USD

The new Approach results in a significant **lower capital requirement** due to the Bank's relatively low historical losses. ***If ILM=1,*** capital under SA would **$ 0.19 Bn USD.** If the losses are higher then the capital charge will be on a higher side.

Mapping loss events as per Basel loss categories

01 Internal fraud:

Losses due to acts of fraud, theft, or misconduct by employees or internal stakeholders

- An employee embezzles funds from customer accounts.
- A trader manipulates investment records to hide losses.
- Unauthorized trading activities leading to financial losses.

02 External fraud:

Losses due to acts of fraud, theft, or information security breaches by external parties

- Forgery of documents to secure loans or investments.
- Cyberattacks leading to theft of client data or funds.
- Phishing scams targeting clients or employees.

03 Clients, Products, and Business Practices:

Losses due to unfailure to meet professional obligations to clients or poor product designintentional or negligent

- Mis-selling of Banking products to clients.
- Breach of fiduciary duty leading to client losses.
- Errors in client account management, such as incorrect interest calculations.

The Basel Committee has identified the following types of operational risk events as having the potential to result in substantial losses

04 Business Disruption and System Failures:

Losses caused by disruptions in business operations or IT system failures.

- Data center failures disrupting banking operations
- Network outages preventing Bank transactions.
- Downtime of trading platforms due to server crashes

05 Execution, Delivery, and Process Management:

Losses arising from legal claims by employees or workplace violations

- Failure to comply with regulatory reporting requirements.
- Errors in trade settlement processes.
- Incorrect processing of client redemption requests.

06 Damage to Physical Assets:

Losses due to damage or destruction of physical assets.

- Fire or natural disasters damaging office infrastructure.
- Damage to IT hardware due to power surges.

07 Employment Practices and Workplace Safety:

Losses arising from employee-related issues or unsafe working conditions.

- Legal costs due to wrongful termination lawsuits.
- Compensation claims for workplace injuries.
- Discrimination or harassment claims by employees

Key Challenges & Mitigation Strategies

Implementing the new framework on operational risk computation and the associated loss data management framework presents several challenges for banks. Below are the key challenges and potential mitigation strategies to address them

Challenge

- Data Quality and Availability
- Defining and Categorizing Loss Events
- Cross-Functional Collaboration
- System Integration
- Lagged Effects
- No formal process to get the operational loss data from the subsidiaries

Description

- Inconsistent or incomplete historical data on business income and losses can lead to inaccurate capital computations. Data may be spread across different systems, making aggregation difficult.
- Operational losses may not be consistently categorized or recorded, leading to misclassification. Some losses may be difficult to attribute to specific business lines or events.
- Implementing the framework requires collaboration across various departments, including risk management, finance, IT, and business units. Ensuring effective communication and coordination can be challenging.
- Integrating the new framework with existing IT systems and data infrastructure can be technically challenging, especially if legacy systems are involved.
- There may be lagged effects where operational losses in one year impact business income in subsequent years. capturing these lagged effects accurately is complex.
- For institutions with financial subsidiaries (excluding insurance entities), there is no process to capture loss data, resulting in the consolidation of BIC but not ILM, leading to an inconsistent approach.

Mitigation Strategy

- Establish a centralized data repository with standardized data collection processes. Implement data validation and cleansing routines to ensure accuracy and completeness.
- Use data reconciliation tools to identify and resolve discrepancies.
- Develop a clear taxonomy for loss events, aligned with regulatory requirements (e.g., Basel III categories).
- Train staff to consistently classify and record losses.
- Define roles and responsibilities for each department (e.g., risk management, finance, IT, business units).
- Appoint a dedicated program manager or steering committee to oversee the implementation.
- Use modular and scalable IT systems to facilitate integration. Partner with technology vendors specializing in risk management solutions.
- Conduct thorough testing and pilot programs before full-scale implementation.
- Analyse historical data to identify patterns and correlations between events and their lagged effects.
- Collect and store detailed data on operational risk events, including root causes, timelines, and outcomes.
- Use this data to build a comprehensive database for analysing lagged effects.
- Institutionalize the process at subsidiary level to capture the loss data and to source that data at group level to compute the consolidated ILM.

Addressing proactively the key challenges mentioned above, bank can ensure a smooth implementation of the guidelines and strengthen operational risk management frameworks by having robust loss data management framework in place.

HOW CAN WE HELP?

Our tailored approach crafted to suit your needs

Key Activities

Diagnostic phase

- As is an assessment of the existing **operational risk framework** i.e., the policies and procedures to understand the coverage regarding the loss data in terms of threshold, collection process, classification/mapping with the Basel loss categories, and reporting to committees if any
- Discuss with risk function on **ownership** and with business units for present capabilities to **identify** and **capture loss** events including **near miss events** along with the **mitigation measures** such as controls or insurance in place
- Review **historical loss data** collected in the last 10 years on a sample basis to ascertain the **level of details** captured and the **root cause** identified

Work Products

Understanding of the present framework and identification of inputs required for the development of the loss data framework based on the maturity and the data availability

Development phase

Loss Data Management Framework

- **Update the OR policy** to capture the components of loss data and capital approach using the new SA
- Develop the **loss data collection template** considering historical or likely losses and the Basel loss categories
- Sensitize the stakeholders on a typical loss data lifecycle with a focus on:
  - Identification
  - Materiality
  - Accounting
  - Recovery
  - Reporting
  - Timing adjustments
- Discuss with risk on how to roll out the loss data template across business units and re-constructing details of historical data basis on a sample basis

Work Products

Development of loss data framework, i.e., templates for the loss data reporting & template for computation of Operation risk capital charge as per the new SA

ORC Computation

Computation of OR Capital Charge

- Map GL-level data with individual line items required for computation of BI i.e., ILDC, SC, and FC
- Apply the appropriate margin coefficient and compute the BIC
- Compute LC and ILM basis the available data and ensure the conditions of high quality are met else assume ILM as 1 as per guidelines
- Compute ORC by multiplying BIC with the ILM and compare with BIA capital
- Suggest necessary changes in the ICAAP document
- Discussion with stakeholders on the impact on the capital under the new standardized approach and obtain sign-off

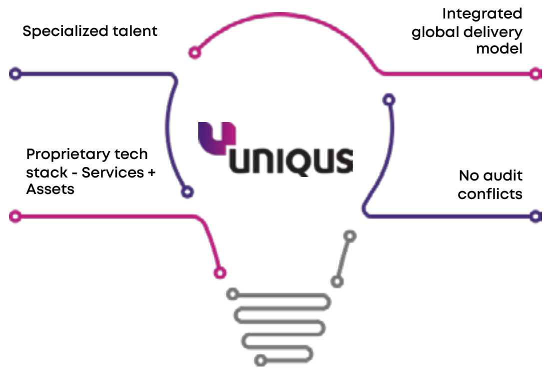
Tangible Outcomes

- Validation / Refresh of overall ORM framework
- Maturity Assessment of ORM Framework
- Target operating model for ORM framework
- Setting up / strengthening the loss data management framework
- Readiness Assessment for Capital Computation under new SA using ILM
- Developmemt of Capital Computation calculator under new SA

WHY UNIQUS

We are a tech-enabled global consultancy and Our Values are central to everything we do

Change the way consulting is done



Market presence: USA | INDIA | UAE | SAUDI ARABIA

- **Agility**
- **Collaboration**
- **Trust**
- **Excellence**
- **Drive impact**

The Uniqus Way

Engage:

Think of us as your partners, as an extension of your business. Our efforts are truly collaborative. We hear you.

Solve:

With deep domain expertise and practical experience, our efforts are solution-oriented. We solve for challenges you face.

Deliver:

Implementing solutions most efficiently, our efforts are measurable for impactful results. We deliver excellence.

Evolve:

We seek feedback and learn from our collective experience. We grow together.

Why Us

Thought leaders:

Jamil Khatri and Sandip Khetan, our co-founders, have been instrumental in building the ARC industry in India. Jamil has also previously led the accounting adviosry practice for KPMG globally. Jamil and Sandip each have over 25 years of experience in partnering with diverse businesses across the globe on their accounting, reporting, and finance function transformation journey. This gives us the unique ability to understand your requirements both strategically and practically.

Deep and diverse talent pool:

We have access to a deep and diverse global talent pool. Partners and other leaders in our ARC practice have significant experience working with the accounting advisory, financial risk management including Operational & non financial risks, audit, finance transformation, treasury, governance risk, compliance, and technology practices of the Big 4 and other large consulting and technology companies globally. Our talent pool is globally integrated working across our key markets of the US, India, and the Middle East.

Global delivery model:

We use an integrated global delivery model where onsite and offshore teams work in a coordinated manner. This enables our clients to access large talent pools at competitive costs when compared to current onsite delivery models.

Integrating financial and non-financial data management:

We believe that financial and non-financial data flows and requirements will merge for external and internal reporting in the future. The increased regulatory disclosures around ESG data will provide impetus to this trend. Given our focus on ESG and ARC, we are well-positioned to help our clients through this journey in an integrated manner.

Our technology-led approach:

Through our technology-led approach, we can not only provide strategic advice and solution but also provide end-to-end implementation assistance. We have a deep understanding and strategic partnerships with tech platforms that enable us to solve automation, data management, and integrity challenges within the finance function.

A TEAM THAT
YOU CAN TRUST TO DELIVER

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