

# Operational risk in the banking sector - a model for insurers?

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ABI, 30 May 2003

- What we mean by operational risk
- Data pooling
  - BBA GOLD
  - Health warnings
  - Other issues
  - Basel and external data
- Quantification
  - Basel standards
  - Assessment and measurement issues
- Basel, CAD and the FSA

# Definition of operational risk

“The risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk, but excludes strategic and reputational risk”  
(Basel,CP3 para 607)

- A definition for regulatory capital rather than risk management purposes.

# Scope of operational risk

Processes includes payment/settlement;  
documentation; valuation/pricing; project  
management; internal/external reporting;  
(mis)selling

People includes fraud; employment law;  
unauthorised activity; loss/lack of key personnel

Systems includes development; implementation;  
failure

External includes external crime; outsourcing risk;  
natural and other disasters; regulatory and political  
risk

# BBA Global Operational Loss Database (GOLD)

- Started collecting data 1 July 2000
- KIS – the best is the enemy of the good
- 110 loss event categories (c.f. Basel 7-20-69)
- 14 business lines (c.f. Basel 8-19)
- Impact/effect (12 categories)
- Hard and soft losses; near misses
- Narrative
- Revisions

# Data pooling - health warnings

- Clarity of purpose, e.g. benchmarking; raw data; VaR modelling; causal; informing scenario analysis. All participants must agree what they want to get out of the database.
- Completeness
  - in banks, most loss data must be manually reported; it does not flow from the GL, therefore its completeness cannot be audited
  - reporting thresholds may vary
  - exclusions, e.g. legal and/or insurance settlements
- Consistency, e.g. commonality of business lines or understanding of loss categories
- Quality differences among participants, including risk appetite; OR reporting culture
- Scaling – a spurious accuracy

# Data pooling - other issues

- Trust
  - participants and data handler
  - participants with each other
  - anonymity
- Validation

Bank operational loss data pools provide *information*, rather than data, and enhance operational risk management rather than the measurement of “severe” losses.

# External data requirements for AMA banks in Basel II

- “relevant”
- “especially when there is reason to believe that the bank is exposed to infrequent, yet potentially severe, losses”
- Loss amounts; scale; information on causes and circumstances of loss events



# Quantitative standards for AMA banks in Basel II

- Distributional assumptions not prescribed
- System must capture potentially severe ‘tail’ events
- A soundness standard comparable to . . . a 1 year holding period and a 99.9% confidence interval
- Capital = sum of EL and UL, unless . . .
- Risk measurement system must “capture the major drivers of risk affecting the shape of the tail”

# Basel II – other assessment issues

- Assessment vs measurement
- Advanced Measurement Approach
  - The “1000 flowers” – “unprecedented flexibility”:  
scorecards; risk self-assessment; VaR/LDA
  - Control factors and (key) risk indicators
  - Scenario analysis – compare RDS?
  - Insurance
- Basel, CAD and the FSA

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