

Operational risk – regulatory update

John Thirlwell

Executive Director, Operational Risk
Research Forum

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- A new timetable?
- Implementation issues
 - Geopolitical
 - Real world
- The Standardised Approach – Basel or EU-lite?
- Advanced Measurement Approach
- Insurance – mitigant or good management?
- Will the regulators achieve their aims?

A new timetable?

- Q2 04 – Basel II published (was Q4 03)
- Feb 04 – Draft EU Directive?*
- June 04 – European Parliament elections*
- Sept 05 – target to complete EU process*
- 2006 – parallel running of Basels I and II
- 1 Jan 07 – Basel II and CAD implementation

Implementation issues – the geopolitics

US implementation

- Basel I or Basel II Advanced – the ANPR
- Investment banks and SEC

EU implementation

- Politics
- Pillar 2

India and China

Implementation issues - the real world

Home/host issues

- Consistency
- Interpretation
- National discretion

Cost, complexity and flexibility

Why be Basel standardised?

CP3, para 609: “Banks are encouraged to move along the spectrum of available approaches . . .”

Standardised Approach

- Gross income by business unit x β (12/18%, incl 18% for corporate finance, trading and sales, payment & settlement)
- Alternative approach – default to highest β
- Business lines - and cost centres
- Qualifying criteria almost identical to Advanced Measurement Approach

Where’s the encouragement?

Try EU standardised – lite

- 11 lines vs 2 pages
- Less detailed requirements for:
 - Operational risk management
 - Operational risk losses
 - Assessment and reporting
 - Validation and data
- Different audiences for Basel and EU, but it all adds to the complexity of implementation

Insurance - mitigant or good risk management?

Insurance as a capital substitute or as it is in reality
AMA only and subject to a 20% cap

Criteria

- Single A claims paying
- Policy term; cancellation and renewal periods
- Exclusions
- Mapping to risk classes/loss event categories
- Captives
- Speed of payment – the dog that did not bark

How do you value a policy? (compare EU CAD premium and limit approaches)

Business environment and external control factors

Advanced Measurement Approach

“Unprecedented amount of flexibility” (CP3 overview para 42)

[Self-]assessment versus measurement

- Range of methodologies encouraged, including scenario analysis, risk indicators
- Quantification language – tail, distributions, 99.9% confidence; EL/UL
- Data versus information
 - Internal (threshold)
 - External (amount, type, date, scaling, health warnings, sources)
 - Operational and credit/market risk loss boundaries and ‘tracking’

Partial use

Will the regulators achieve their aims?

Ensuring firms hold adequate capital for high-impact, unexpected events

Incentivising good risk management practices

Raising awareness of operational risk as a threat to global financial stability

Raising awareness of operational risk as a proper topic for senior management concern and involvement, c.f. Turnbull

John Thirlwell

Tel: +44 (0)20 8386 8019

Email: info@johnthirlwell.co.uk