

Banks need to address **operational risk**

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Operational risk of Basel II poses some of the greatest challenges banks face today, though banks have struggled to perceive, quantify, and manage it. Since very few cases of operational process failures have been publicly reported, banks have failed to address the risk it is exposed to in the absence of adequate operational risk management measures.

What is to be seen is that the impact of operational risk is often not felt in one account only and it may not appear as a tangible loss at all. Consequently, broad-scale, enterprise-wide business buy-in for operational risk initiatives have proved slow to develop.

In Basel II document, operational risk is defined as 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 reputation risk. Some examples of operational risk are like losses arising because of internal or external frauds, natural disaster, failed transaction processing or inability to meet the commitment, disruption of business or system failures.

There are three suggested methodologies for calculating operational risk capital charges: (1) the basic indicator approach (BIA); (2) the standardized approach; and (3) advanced measurement approaches (AMA). Internationally-active banks and banks with significant operational risk exposures are expected to use an approach that is more sophisticated than the BIA approach and that is appropriate for the risk profile of the institution.

In BIA approach, banks are supposed to hold capital for operational risk equal to the average over the previous three years of a fixed percentage of positive annual gross income. Gross income is defined as net interest income plus net non-interest income. The Basel committee has set 15% as the fixed percentage of the gross income to be considered as operational risk and in any of the previous years gross income is negative or zero then it should be ignored. The BIA approach is the simplest and easiest to be applied. The only care that needs to be taken is gross income be computed as per the guidelines of Basel.

In this approach the bank's activities are divided into eight business lines and gross income of each business line act as a scale to measure operational risk within each of these business lines. Similar to the BIA approach, the total capital charge is calculated as the 3-year average of the simple summation of the regulatory capital charges across each of the business lines in each year. However if the aggregate capital charge across all business lines within a given year is negative, then the capital charge for that year is considered to be zero.

The third methodology as suggested by the Basel committee for computing the operational risk is advanced measurement approach (AMA). In the AMA approach the regulatory capital requirement will equal the risk measure generated by the bank's internal operational risk measurement system.

Implementing the AMA approach would be a real challenge for banks not only in India but also across the globe, because till date banks were focussing on credit risk and market risk and very little emphasis was laid on operational risk. Going by the Basel documents quantitative and qualitative criteria for using AMA, it appears that the banking industry will take at least 5 years before they can start using the AMA.

The first and foremost qualifying criteria for AMA as mentioned in the Basel document is that the bank must have an operational risk management system with clear responsibilities assigned to an operational risk management function (ORMF). The ORMF would be responsible for developing strategies to identify, assess, monitor and control/mitigate operational risk; for setting policies and procedures concerning operating risk management and controls; for design and implementation of the risk assessment methodology, and designing and implementing risk-reporting system for operational risk.

Now coming to the quantification part of the AMA, the most important data is the internal loss data. At least 3 years' historical data on internal loss is required for developing operational risk models to quantitatively estimate operational risk. Operational risk management would require banks to clearly define its risk strategy and lay down detailed guidelines with regard to policies and organization structure to be implemented.

It is a must that not only the top management supports this initiative but each business line understands the importance of operational risk management. They have to ensure that it is established in their respective departments and is in line with the overall organizational system. It should concentrate not only on its past record to analyse the operational risks it is exposed to but also take help of external data available in public domain or data shared by banks, if any.

The internal loss data collection for the past is a tough exercise but prospectively, banks can aim at keeping a complete record of it and enrich it over time by sharing it with its counterparts. The external public data has to be cautiously screened and adjusted to ensure it fits the bank's specific environment of processes, systems, and people.

While writing this article, the incessant rains struck Mumbai, providing a realistic example of operational risk. The complete infrastructure went haywire and losses of crores of rupees were reported. Such events, though cannot be accurately predicted and prepared for, we need to have a disaster control mechanism to take care of such extreme eventualities and Basel II accord aims for the same by asking banks to maintain adequate capital back-up for operational risks, too.

Considering the time and resource that would be required to implement operational risk management procedures, banks should plan out their approach. The first critical milestone would be to identify the various sources of operational risk to which the bank is exposed and take appropriate measures to mitigate it, be it insuring the property, setting up redundant backup facilities, periodic internal audits to prevent frauds.

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