Towards Standardized Measurement Approach in Banks with Integrated ORM Framework
With the publication of two consultative documents – d3551 and d3562 – by the Basel Committee on Banking Supervision (BCBS) in March 2016, banks have had to re-think their operational risk management (ORM) framework implementations. Document d355, which provides the methodology to get the operational risk capital charge, explains that the Committee has proposed withdrawal of the Advanced Measurement Approach (AMA) and instead, suggested a new Standardized Approach for the measurement of the capital charge for operational risk. This idea has been presented in G-20 summit too. Document d356, which deals with disclosure, explains that existing operational risk reports are still valid but few more reports have been added to the bundle. Thus, the banks using AMA for their capital charge calculation have to redesign their framework as per the new regulations and along with it they have to incorporate the new reports into their overall disclosure framework.

These regulations are applicable on internationally active banks and other active Institutions which have decided to apply the Standardized Measurement Approach (SMA). Banks have the huge task of combining the new regulations, which are part of Pillar 1 and 3 of the Basel Framework3, with the existing Pillar 2 implementations, which provide source data for capital charge calculations and reports.

To meet the requirements, the industry needs an integrated framework which has bundled together general ledger, governance risk and compliance, capital charge calculation, and disclosure framework, and can also provide maximum automation to reduce time and effort in transferring and managing data between environments. However, the industry is currently managing with disintegrated frameworks which make the task of monitoring the growth in capital charge and establishing controls at the right time difficult. BCBS will declare the timeline for implementation in 2016 and banks need to harness the right approach to gain compliance.

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What is missing in existing ORM frameworks?

The existing ORM solutions for BCBS compliance use multiple tools to get the capital charge and data supplied to different systems manually. These frameworks use the Governance, Risk and Compliance (GRC) tool to store operational risk data, which is then migrated to a statistical tool using traditional techniques and Pillar 1 capital charge is calculated as per AMA provisions (see Figure 1). Similarly, these data are then used by a traditional reporting tool to generate disclosure reports. In these solutions, the general ledger, governance, risk and compliance work in different spectrums and lack integration. In fact, the components of existing ORM solutions are kept remote in different systems which leads to delay in generating results any time as data need to be migrated manually. This causes difficulties in monitoring the growth in capital charge and taking decisions. So, the capital charge for a year may increase than the provisioned amount and cause complexities. The use of traditional techniques to feed data into systems consume a lot of effort, giving rise to the demand for an automated solution that can fetch source data directly.

The need to put calculations in place, develop disclosure reports, and mitigate operational risks calls for manual work which consumes a lot of time and effort. So, the industry is in need of a single tool implementation that provides maximum automation.

Figure 1 - Current framework for operational risk pillar 1 and 3 in banks
At the center of the new framework is a GRC tool which is used to implement both Pillar 2 of Basel framework for operational risk as well as the principles for the sound management of operational risk. The solution is built on top of it to provide an integrated framework to include Pillar 1 and 3. This leads to an integrated ORM framework with all the pillars implemented. The solution uses the existing components of the GRC tool and custom components may be created to hold the financial information needed for Pillar 1 and 3 results. For example, accounts can be configured having mapped child...
accounts and more granular level accounts as per the organization need. The model can have as much detail as required such as starting the mapping from general ledger information or from more granular items, to the accounts. The ultimate goal is integrating the financial and loss information. The solution imports latest financial data on a single click and updates the objects related to accounts. The user may even use existing stored data of GRC tool and not update them.

Similarly, one can use the latest loss data after importing them with a single click or use the existing stored data before the update. The application for Capital Charge Calculation and Reporting that comes with the solution provides the Business Indicator (BI) from the financial data. It also provides the BI component as per the buckets given by the BCBS. To generate risk sensitivity, the regulator has suggested the use of internal loss data of the organization in the system. So, losses faced by an organization are used in the calculation. The application automatically fetches internal loss data from the GRC tool and generates the internal loss component. And using these, operational risk capital charge is found. The organization can have the application run for any time period and retrieve results. The application also provides navigation links for automated disclosure reports. The user can navigate and view all the disclosure reports one by one. Thus, with a single click, without any manual effort, both the requirements for Pillar 1 and 3 are met. If Pillar 2 is implemented using the same GRC tool then the solution gives rise to an integrated overall Operational Risk Framework (see Figure 2).

To sum up, the SMA Framework is a readymade solution that offers regulatory capital charge and disclosure reports with general ledger, GRC, capital charge calculation and disclosure reporting integrated in the same framework. It prevents loss of time and effort in feeding data to different environments as the solution is mostly automated. Because of 'one-click result' the daily or monthly monitoring of the growth of capital charge is also made easy. So, controls can be applied on time to reduce losses and capital charge can be kept below the provisioned amount. Also, this tool and vendor-agnostic solution reduces multiple costs and maintenance. It has an integrated approach for both Pillar 1 and 3 at a single point of time and by implementing Pillar 2 requirements in the GRC tool, it becomes an integrated operational risk management framework.
References

1. The document ‘Standardized Measurement Approach for Operational Risk, March 2016’ can be found at http://www.bis.org/bcbs/publ/d355.htm
2. The document ‘Pillar 3 disclosure requirements – consolidated and enhanced framework, March 2016’ can be found at http://www.bis.org/bcbs/publ/d356.htm
3. Basel II framework provides the details of the three pillars and can be found at http://www.bis.org/publ/bcbs128.htm. The three pillars are strengthened more in Basel III http://www.bis.org/list/bcbs/tid_132/index.htm

About the author

Abhijit Brahmachary is a senior consultant with over three and half years of experience in Operational Risk Framework, GRC, Data Warehousing, Data Quality, Reporting, and Analytics, among others. He is currently responsible for building frameworks, reports and solutions in the area of ORM. He is also a trainer in the Risk and Compliance space.

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