



# Discussion Paper

## **Implementation of the Basel II Capital Framework 2. Standardised approach to operational risk**

28 July 2005

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## Introduction

As foreshadowed in APRA's first discussion paper on the implementation of the Basel II Capital Framework (April 2005), this paper introduces the draft prudential standard for the standardised approach to operational risk, *APS 114 Capital Adequacy: Standardised Approach to Operational Risk* (APS 114).

One of the most significant differences between the 1988 Basel Capital Accord and the Basel II Framework is the introduction of a regulatory capital charge for operational risk. Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. The definition includes legal risk but excludes strategic and reputational risk.

Consistent with the approach taken for credit risk, the Basel II Framework includes a number of alternative options for determining the regulatory capital charge for operational risk. These approaches range from relatively simple methodologies to more sophisticated approaches based on an authorised deposit-taking institution's (ADI's) own quantitative model. As with the regulatory capital charge for credit risk, APRA expects that the vast majority of Australian banks, building societies and credit unions will use the standardised approach in determining their regulatory capital charge for operational risk. Australia's internationally operating banks are seeking to implement the advanced measurement approaches to operational risk upon implementation of the Basel II Framework.

## Prudential standard

APS 114 sets out the methodology for the calculation of the regulatory capital charge for operational risk under the standardised approach. The main aspects of the draft standard are:

- an ADI's activities are divided into two areas of business: 'retail/commercial banking' and 'all other activity';

- the operational risk capital requirement for the retail/commercial banking area of business is determined as a proportion of loans and advances relating to those activities; and
- the operational risk capital requirement for the all other activity area of business is determined as a proportion of an ADI's net income, excluding net income relating to retail and commercial banking activities.

All ADIs will be required to have in place a comprehensive risk management framework for operational risk. The requirements of this framework will be separately detailed in a risk management prudential standard that will be released in 2006.

The draft APS 114 is available on the APRA web site [www.apra.gov.au](http://www.apra.gov.au). Written submissions on the draft standard should be forwarded by 31 December 2005 to:

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## Policy issues surrounding APS 114

### Implementation of the alternative standardised approach to operational risk in Australia

APRA is proposing that ADIs that are not approved by APRA to use the advanced measurement approaches to operational risk use the alternative standardised approach (ASA), which uses an asset indicator for ADIs' main business lines. The basic indicator and standardised approaches proposed by the Basel Committee on Banking Supervision (the Basel Committee) use gross income<sup>1</sup> as the risk indicator and produce wide variations in outcomes among ADIs that cannot be tied readily to differences in operational risk.<sup>2</sup>

<sup>1</sup> Under the basic indicator approach, the capital charge is 15 per cent of average annual gross income over the previous three years. Under the standardised approach, a bank's activities are divided into eight business lines and factors ranging between 12 and 18 per cent are applied to gross income for each line. Under the ASA, for retail and commercial banking business lines, loans and advances replace gross income as the proxy indicator.

<sup>2</sup> Further detail on the outcome of the operational risk capital charge under the basic indicator and standardised approaches is available in *APRA Insight Quarter 4 2004*.

APRA is proposing that the Basel Committee's ASA is the entry point for the calculation of operational risk regulatory capital for ADIs. Consistent with the terminology used for the comparative credit risk methodology, this approach will be called the 'standardised approach to operational risk'.

### **Aggregation of business lines**

APRA is committed to keeping the regulatory capital requirement for smaller ADIs as simple as possible. The ASA proposals in the Basel II Framework require ADIs to map their activities into eight business lines. This classification of activities may be difficult for some ADIs and may be an undue burden on ADIs' resources. In addition, an ADI's capacity to map its activities to business lines does not necessarily mean that the ADI has better operational risk management and hence, less operational risk. The aggregation of activities into two areas of business simplifies the regulatory capital methodology without significantly dampening the sensitivity of the approach or materially increasing the regulatory capital charge.

As currently drafted, APS 114 requires ADIs to aggregate retail and commercial banking activities into one area of business and separately aggregate all other activities into one other area of business. For the retail and commercial banking area of business, a proportion of loans and advances is used as the proxy for the scale of business operations and thus the likely scale of operational risk exposure for that activity. Gross income is used as the proxy indicator for the all other activity area of business. Factors of 15 and 18 per cent, respectively, have been proposed for the two aggregated areas of business. These factors serve as industry-wide estimates for the relationship between the operational risk loss experience for each area of activity and the proxy indicators (that is, loans and advances or gross income as appropriate). In practice, for most credit unions and building societies, the majority of activities will map to the retail and commercial banking area of business.

In requiring the aggregation of business lines, it is not APRA's intention to restrict the introduction of a more risk sensitive approach to the calculation of operational risk capital requirements at some point in the future. APRA has therefore committed itself to re-assessing its decision to aggregate business lines once more data on operational risk losses become available.

### **Refinements to simplify implementation**

For the purpose of calculating the operational risk regulatory capital charge, rather than aggregate net income for all other non-retail/commercial banking activities, APS 114 will allow an ADI to use a base income figure from its regulatory reporting return, that is, profit from ordinary activities before goodwill amortisation and income tax. From this amount, the ADI will strip out material income and expense items that relate primarily to retail and commercial banking activities as the operational risk associated with those activities is captured in the retail/commercial banking area of business.

The specific items that can be stripped out from the base income figure are net:

- interest income from loans and advances included in the retail/commercial banking area of business;
- fees from automatic teller machine networks;
- fees from retail and commercial transaction accounts; and
- fees from loans and advances included in the retail/commercial banking area of business.

APRA will also allow other items to be excluded from net income where an ADI can demonstrate that the operational risk capital requirement for the retail/commercial banking area of business adequately captures the operational risk associated with the activities to which the items relate.



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