

Chapter 1 : Basel Committee - BIS - Operational risk

Topics discussed include: Basel Accord II, getting ready for the New Basel III, Extreme Value Theory, the new capital requirements and regulations in the banking sector in relation to financial reporting (including developing concepts such as OpRisk Insurance which wasn't a part of the Basel II framework).

The ratio would apply to certain U. The LCR consists of two parts: The proposal would require: That amount would be determined based on the peak cumulative amount within the day period. Notably, the Fed chose not to include GSE-issued securities in Level 1, despite industry lobbying, on the basis that they are not guaranteed by the "full faith and credit" of the U. The proposal requires that the LCR be at least equal to or greater than 1. Summary of originally-proposed changes in Basel Committee language[edit] First, the quality, consistency, and transparency of the capital base will be raised. Provide incentives to strengthen the risk management of counterparty credit exposures Raise counterparty credit risk management standards by including wrong-way risk Third, a leverage ratio will be introduced as a supplementary measure to the Basel II risk-based framework. Put a floor under the buildup of leverage in the banking sector Introduce additional safeguards against model risk and measurement error by supplementing the risk based measure with a simpler measure that is based on gross exposures. Fourth, a series of measures is introduced to promote the buildup of capital buffers in good times that can be drawn upon in periods of stress "Reducing procyclicality and promoting countercyclical buffers". Measures to address procyclicality: Dampen excess cyclicality of the minimum capital requirement; Promote more forward looking provisions; Conserve capital to build buffers at individual banks and the banking sector that can be used in stress; and Achieve the broader macroprudential goal of protecting the banking sector from periods of excess credit growth. Requirement to use long-term data horizons to estimate probabilities of default, downturn loss-given-default estimates, recommended in Basel II, to become mandatory Improved calibration of the risk functions, which convert loss estimates into regulatory capital requirements. Banks must conduct stress tests that include widening credit spreads in recessionary scenarios. Promoting stronger provisioning practices forward-looking provisioning: Advocating a change in the accounting standards towards an expected loss EL approach usually, EL amount: In January, the oversight panel of the Basel Committee on Banking Supervision issued a statement saying that regulators will allow banks to dip below their required liquidity levels, the liquidity coverage ratio, during periods of stress. On 11 March, the Basel Committee on Banking Supervision released the second of three proposals on public disclosure of regulatory metrics and qualitative data by banking institutions. The proposal requires disclosures on market risk to be more granular for both the standardized approach and regulatory approval of internal models. The Federal Reserve Board itself would conduct tests annually "using three economic and financial market scenarios". Institutions would be encouraged to use at least five scenarios reflecting improbable events, and especially those considered impossible by management, but no standards apply yet to extreme scenarios. Only a summary of the three official Fed scenarios "including company-specific information, would be made public" but one or more internal company-run stress tests must be run each year with summaries published. Credit exposure between the largest financial companies would be subject to a tighter limit". One or more "triggers for remediation" such as capital levels, stress test results, and risk-management weaknesses "in some cases calibrated to be forward-looking" would be proposed by the Board in

Operational Risk toward Basel III Founded in , John Wiley & Sons is the oldest independent publishing company in the United States. With offices in North America, Europe, Australia, and Asia, Wiley is globally committed to developing and marketing print and electronic products and services for our customers' professional and personal knowledge and understanding.

As one financial institution after another is failing or is subjected to an emergency sale, we start to comprehend that the basic rules of banking are in the process of being fundamentally redefined. A significant fallout for the real economy is by now more than likely, and the resulting political tremors will have a potentially decisive impact on the November elections. The reported loss figures are staggering and of almost incomprehensible magnitude for the average citizen. The rescue of the German IKB has, for instance, led to accumulated losses of 9 billion euros so far, an amount that is equivalent to an extra burden of approximately euros for every taxpayer. Hundreds of billions of dollars need to be committed as part of the U. While the crisis is clearly of a systemic nature, its ultimate source lies with the notoriously myopic behavior of the banking community and, as some commentators have argued, is the outcome of collective greed. Bankers have increasingly viewed their careers as long call options that, in the worst case, could force them into a lengthy retirement in a lavish country home. Betting the bank by taking on excessive liquidity risk exposures was ultimately acceptable because the buildup of counterparty risk made a governmental bailout all the more likely. Industry insiders have warned for quite some time that credit volume growth far exceeding economic growth has historically always led to some form of a financial crisis. Without question, it is particularly worrisome that the whole problem did not appear on the radar of regulatory authorities until it was too late. The subprime crisis and its fallout in financial markets as well as the real economy will trigger far-reaching regulatory reforms and should also lead to a toughening of the penalty structure for bankers in charge of running complex financial market operations. It, however, also requires institutional efforts by banks to reexamine and strengthen their approaches to risk management. Trading and credit risk management systems must obviously be extended to capture liquidity risk exposures. It will require changes in the governance structures and the development of adequate back-office systems. We are still in the early stages of developing a sound understanding of operational risk management. Hence, there is still considerable scope for academics to make valuable contributions with their ongoing research. It provides a comprehensive coverage of this exciting field, ranging from quantitative and qualitative risk measurement approaches to risk mitigation and regulatory implications. The edited volume includes American as well as European viewpoints and brings together academics as well as practitioners. The 23 chapters in total cover a lot of ground and give readers an in-depth overview of the current state of the art in operational risk management. While the contributors could not fully predict recent events, their contributions are nevertheless strongly influenced by the financial market woes of the past 14 months. This volume will therefore shape the discussion on how to better shield financial institutions against operational breakdown in future years. He has written over 50 articles on hedge funds and managed futures in various peer-reviewed publications. I am also deeply indebted to Dr. Finally, I thank the handful of anonymous referees who assisted in the selection and review process of the chapters in this text. Neither the editor nor the publisher is responsible for the accuracy of each individual chapter. After spending one year as a visiting scholar at the Department of Mathematics of the Indiana University and receiving a PhD in Mathematical Statistics from the University of Trento in he has held positions at the Risk Management department of Banca Intesa in Milan from to His current research interests focus on quantitative risk management and computational statistics. His prior professional experience includes commodities derivatives trading at First Chicago Capital Markets, stock options research and CBOE market-making for Hull Trading Company, and building stock selection models for mutual funds and hedge funds for Chicago Investment Analytics. He has also served as a research consultant to an equity brokerage firm and a hedge fund marketing firm. He is the author of *Managing a Hedge Fund*, which was named to the list of the top 10 books of by the Financial Engineering News. Black previously served as an assistant professor at the Illinois Institute of

Technology, where he taught a variety of courses in portfolio management and alternative investments, including equity valuation, hedge funds, and enterprise formation and finance. He studied theoretical physics at the Munich University of Technology. His main research interest is quantitative finance with special focus on risk integration and operational risk. His research is concentrated in the areas of corporate governance and corporate financial reporting. She has almost four decades of experience in the public and private sector, as a merchant banker, regulator, internal auditor, and financial trainer. For the last 15 years she has been a Senior Lecturer in Financial Services at the University of Technology Sydney UTS as well as Managing Director of her own consulting company and several private investment companies. Her main research interests are the pricing of services, customer service, and business models. His main research interests concern spatial econometrics and applied statistics. He is a well-experienced academic with a corporate finance background, and he is well published in internationally refereed journals in financial economics and corporate finance. He graduated with honors from the Department of Economics at the University of Bologna Italy in He is a specialist in time series analysis, financial econometrics, multivariate dependence in finance, and economics with more than 20 publications. Nigel Finch is a lecturer in Management at the Macquarie Graduate School of Management, specializing in the areas of managerial accounting and financial management. His research interests are in the areas of accounting and management decision making, finance and investment management, and financial services management. Finch worked as a financial controller for both public and private companies operating in the manufacturing, entertainment, media, and financial services industries. Subsequently he worked as an investment manager specializing in Australian growth stocks for institutional investment funds. Guy Ford is Associate Professor of Management at Macquarie Graduate School of Management, where he teaches in the areas of financial management, corporate acquisitions, corporate reconstructions, and financial institutions management. He is a founding coeditor of the Journal of Law and Financial Management. He specializes in energy, environmental, and financial risk. He has published many books and articles in refereed journals, including Managerial Finance, the European Journal of Finance, and the Journal of Economic Dynamics and Control. His research interests are in risk measurement and management, pricing of assets subjected to credit risk, credit scoring models, back-testing of rating systems, statistical analysis of subjective information, Bayesian networks, and econometrics. His main advisory experiences concern the development of credit rating systems and the development of approaches for the subjective analysis of risks. The author of more than articles and more than a dozen books, his current research and development activities and projects focus on risk management, rating, strategy development, the development of methods for aggregating risks, value-based management valuation, decision making under uncertainty, and imperfect capital markets. Werner lectures at various universities in the field of rating, risk management, value-based management, and entrepreneurship. His research focuses on structured finance, risk management, sovereign debt management, financial regulation, and time series econometrics. He was also educated in Oxford, Cambridge, Leicester, and Maryland. Jobst is a regular speaker at professional and academic conferences on risk management and structured finance. 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She is an Elected Fellow of the Institute of Mathematical Statistics, a member of the Editorial Board of the Springer Finance book series, and associate editor of several scientific journals. Besides numerous publications in scientific journals, Dr. His main interests are corporate finance and capital markets. His papers have been published in the Journal of Business Administration, International Journal of Business Management and Economics, and other journals. He is also a part-time adviser of a leading company in the Turkish Logistics industry. Krawiec is a Professor of Law at the University of North Carolina and has

taught at many other law schools, including Harvard, Virginia, and Northwestern. She teaches courses in securities, corporate, and derivatives law. Representative recent publications include: Zeiler , 91 VA. Baker , U. He is a recognized expert in the fields of project and risk management and is the author of numerous publications, including Organized Opportunities: Her current research interests include nonparametric density and regression estimation, mixed-effects model, and survey sampling. He holds a degree in actuarial science from Copenhagen and in statistics from UC-Berkeley. He is coauthor of about 50 scientific papers in journals of actuarial science, econometrics, and statistics. Her research interests are on risk measurement and management, asset allocation and household portfolios, hedge funds, financial institutions, and financial crisis. She participates in many research projects and has acted as a referee for many prestigious journals. His expertise focuses on risk measurement and management for financial institutions, and he was actively involved in numerous Basel II-related assignments for institutions in Luxembourg, Belgium, Norway, United Arab Emirates, and South Korea. Beside his practical experience, Mr. Peters is the author of several academic publications on operational risk modeling. He received his PhD in Finance and his M. Rouah is the coauthor and coeditor of five books on hedge funds and option pricing, and his research is published regularly in peer-reviewed academic journals. His research interests and publications concern the application of the theory of extreme values to geophysical phenomena and the modeling of multivariate extreme events via copulas. He is well published in international refereed journals of economics and financial economics on the broad research areas of international banking and finance and international risk management. Previously he was assistant professor in the Department of Management at Fatih University. Before joining Fatih University, he worked for American Express in the United States in international risk management, international information management, information and analysis, and fee services marketing departments. His main interests are applied finance and international finance. His primary research interest is in applied econometrics, econometric theory, and nonparametric inference. Currently he is responsible for the regulation and supervision of the Italian securities settlement system and central clearing counterparty. Over the last years he took part in several national and international groups in the field of financial markets posttrading systems. Sundmacher is enrolled in a PhD degree at the Macquarie Graduate School of Management and researches in the areas of capital markets and risk management in financial institutions. Former teaching positions were at Hannover, Munich, and Dresden. Professor Wagner has coauthored several international contributions, for example, articles in Economic Notes, Quantitative Finance, the Journal of Banking and Finance, and the Journal of Empirical Finance. He regularly serves as a referee for finance and economics journals. His research interests include empirical asset pricing, applied financial econometrics, and market microstructure as well as banking and risk management. His industry background is in quantitative asset management with HypoVereinsbank and Munich Financial Systems Consulting. He was a Boas Assistant Professor of Mathematics at Northwestern University from to , after visiting Northwestern with a research grant from the German Research Council in In he was awarded a EU grant and visited the University of Genoa.

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Background[edit] Until Basel II reforms to banking supervision, operational risk was a residual category reserved for risks and uncertainties which were difficult to quantify and manage in traditional ways [5] – the "other risks" basket. Such regulations institutionalized operational risk as a category of regulatory and managerial attention and connected operational risk management with good corporate governance. Of course, businesses in general, and other institutions such as the military, have been aware, for many years, of hazards arising from operational factors, internal or external. The primary goal of the military is to fight and win wars in quick and decisive fashion, and with minimal losses. For the military, and the businesses of the world alike, operational risk management is an effective process for preserving resources by anticipation. Two decades from the early s of globalization and deregulation e. Big Bang financial markets , combined with the increased sophistication of financial services around the world, have introduced additional complexities into the activities of banks, insurers and firms in general and therefore their risk profiles. Since the mids, the topics of market risk and credit risk have been the subject of much debate and research, with the result that financial institutions have made significant progress in the identification, measurement and management of both these forms of risk. However, the near collapse of the U. The list of risks and, more importantly, the scale of these risks faced by banks today includes fraud, system failures, terrorism and employee compensation claims. The identification and measurement of operational risk is a real and live issue for modern-day banks, particularly since the decision by the Basel Committee on Banking Supervision BCBS to introduce a capital charge for this risk as part of the new capital adequacy framework Basel II. Scope exclusions[edit] The Basel II definition of operational risk excludes, for example, strategic risk – the risk of a loss arising from a poor strategic business decision. Other risk terms are seen as potential consequences of operational risk events. For example, reputational risk damage to an organization through loss of its reputation or standing can arise as a consequence or impact of operational failures – as well as from other events. Basel II seven event type categories[edit] The following lists the seven official Basel II event types with some examples for each category: It should be noted however that these models are only as good as the underlying assumptions, and a large part of the recent financial crisis arose because the valuations generated by these models for particular types of investments were based on incorrect assumptions. By contrast it is relatively difficult to identify or assess levels of operational risk and its many sources. Historically organizations have accepted operational risk as an unavoidable cost of doing business. Many now though collect data on operational losses – for example through system failure or fraud – and are using this data to model operational risk and to calculate a capital reserve against future operational losses. In addition to the Basel II requirement for banks, this is now a requirement for European insurance firms who are in the process of implementing Solvency II, the equivalent of Basel II for the insurance sector. To complement these standards, Basel II has given guidance to 3 broad methods of capital calculation for operational risk: Basic Indicator Approach – based on annual revenue of the Financial Institution Standardized Approach – based on annual revenue of each of the broad business lines of the Financial Institution Advanced Measurement Approaches – based on the internally developed risk measurement framework of the bank adhering to the standards prescribed methods include IMA, LDA, Scenario-based, Scorecard etc. The operational risk management framework should include identification, measurement, monitoring, reporting, control and mitigation frameworks for operational risk. There are a number of methodologies to choose from when modeling operational risk, each with its advantages and target applications.

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