

Supervisory guidance to supplement BCR amendments for implementing Basel III revised operational risk capital framework¹

Table A - BI Components (re OPE10.2 Table 1 of Basel Framework)

	Income statement or balance sheet items	Description	Typical sub-items	Reference in proposed BCR amendments
(i)	<i>Interest, leases and dividend component (ILDC)</i>			
1	Interest income	Interest income from all financial assets and other interest income (including interest income from finance and operating leases and profits from leased assets)	• Interest income from loans and advances, assets available for sale, assets held to maturity, trading assets, finance leases and operating leases • Interest income from hedge accounting derivatives • Other interest income • Profits from leased assets	Item 7(14)
2	Interest expenses	Interest expenses from all financial liabilities and other interest expenses (including interest expenses from finance and operating leases, depreciation and impairment of operating lease assets, and losses from leased assets)	• Interest expenses from deposits, debt securities issued, finance leases and operating leases • Interest expenses from hedge accounting derivatives • Other interest expenses • Losses from leased assets • Depreciation and impairment of operating lease assets	Item 7(13)

¹ This supervisory guidance may take the form of a Code of Practice (“CoP”) or a supervisory policy manual module, etc., to be issued by the Monetary Authority (“MA”). A CoP is one to be issued by the MA under section 97M of the Banking Ordinance.

	Income statement or balance sheet items	Description	Typical sub-items	Reference in proposed BCR amendments
3	Interest earning assets	Total gross outstanding loans, advances, interest bearing securities (including government bonds and zero coupon bonds) and leased assets, including those in non-accrual status		Item 7(12)
4	Dividend income	Dividend income from investments in stocks and collective investment schemes not consolidated in the AI's financial statements, including dividend income from non-consolidated subsidiaries, associates and joint ventures		Item 7(4)
(ii) Services component (SC)				
5	Fee and commission income	Income received from providing advice and services (including income received by the AI for providing outsourcing services)	Fee and commission income from: • Securities (issuance, origination, reception, transmission, execution of orders on behalf of customers) • Clearing and settlement • Asset management • Custody • Fiduciary transaction • Payment services • Structured finance • Servicing of securitizations • Loan commitments and guarantees given • Foreign transactions (e.g. foreign exchange, remittance)	Item 7(7)
6	Fee and commission expenses	Expenses paid for receiving advice and services (including outsourcing fees paid	Fees and commission expenses from: • Clearing and settlement	Item 7(6)

	Income statement or balance sheet items	Description	Typical sub-items	Reference in proposed BCR amendments
		by the AI for the supply of financial services, but not outsourcing fees paid for the supply of non-financial services such as those on logistics, IT, human resource)	• Custody • Servicing of securitizations • Loan commitments and guarantees received • Foreign transactions (e.g. foreign exchange, remittance)	
7	Other operating income	Income from ordinary banking operations not included in but of a similar nature to any of the other items (under the column of “Income statement or balance sheet items”) in this table, excluding income from operating leases	• Rental income from investment properties • Gains from non-current assets and disposal groups classified as held for sale not qualifying as discontinued operations (measured in accordance with IFRS 5.37 or HKFRS 5)	Item 7(22)
8	Other operating expenses	Expenses and losses from ordinary banking operations not included in but of a similar nature to any of the other items (under the column of “Income statement or balance sheet items”) in this table, and from operational loss events, excluding expenses from operating leases	• Losses from non-current assets and disposal groups classified as held for sale not qualifying as discontinued operations (measured in accordance with IFRS 5.37 or HKFRS 5) • Losses incurred as a consequence of operational loss events (e.g. fines, penalties, settlements, replacement cost of damaged assets), which have not been provisioned/reserved for in previous years • Expenses related to establishing	Item 7(21)

	Income statement or balance sheet items	Description	Typical sub-items	Reference in proposed BCR amendments
			provisions/reserves for operational loss events	
(iii)	<i>Financial component (FC)</i>			
9	Net P&L on trading book	• Gains minus losses on trading assets and trading liabilities (e.g. derivatives, debt securities, equity securities, loans and advances, short positions, other assets and liabilities) • Gains minus losses from hedge accounting • Gains minus losses from exchange differences		Item 7(19)
10	Net P&L on banking book	• Gains minus losses on financial assets and liabilities measured at fair value through the profit and loss account • Realised gains minus losses on financial assets and liabilities not measured at fair value through the profit and loss accounts (e.g. loans and advances, assets available for sale, assets held to maturity, financial liabilities measured at amortised cost) • Gains minus losses from hedge accounting • Gains minus losses from exchange differences		Item 7(18)

Table B - Standards for high quality operational loss data (re item 7(9) of proposed BCR amendments)

Item	Particulars	Basel Framework reference
1	An AI must have documented policies, procedures and processes to manage operational loss data for capital calculation purposes covering: (i) end-to-end system design for identification, collection, aggregation and treatment of the data; (ii) storage, retention, archiving and as applicable deletion of the data; and (iii) back-up of the data, and such policies, procedures and processes must be subject to: • validation before the loss data can be used for the calculation of capital charge for operational risk under Part 9 of the BCR; and • regular independent reviews by internal or external auditors or other capable parties.	OPE25.16
2	An AI must classify and document the criteria for classifying an operational loss event into one of the event-type categories specified in Table C in accordance with the description, categories and activity examples described in the Table.	OPE25.17
3	An AI must capture operational loss data from- • all material activities and exposures; • all appropriate systems and subsystems and • all geographic locations.	OPE25.18
4	An AI must maintain operational loss data for an operational loss event if the cumulative operational losses arising from the event after deduction of recoveries over the calculation period as applicable to the AI is more than or equal to HK\$200,000.	OPE25.18. € is converted into HK\$ at an exchange rate of €1 = HK\$10.

Item	Particulars	Basel Framework reference
5	The operational loss data for an operational loss event referred to in item (4) must include the information as set out in <u>Table D</u> .	OPE25.19
6	An AI must have processes to independently review the comprehensiveness and accuracy of the operational loss data.	OPE25.22
7	An AI must maintain records of payments received for recovery of operational losses. If requested by the MA, the AI must produce the records to the MA for inspection.	OPE25.25
8	An AI must build its loss data set based on the “date of accounting” (see item 1 “reference dates” in <u>Table D</u>).	OPE25.28
9	Losses and related recoveries caused by a common operational loss event or by related operational loss events over time but posted to the accounts over several years should be allocated to the corresponding years in line with their accounting treatment.	OPE25.29
10	The scope of losses used to calculate the operational risk capital requirements must include acquired businesses and merged entities over the period prior to the acquisition/merger that is relevant to the calculation.	OPE25.34

Table C – Classification of operational loss events (re OPE25.17 Table 2 of Basel Framework / item 7(20) of proposed BCR amendments)

An AI should regard as an operational loss event any event that falls within any of the event-type categories based on the classification guidance tabulated as follows:

Event-type category	Description	Categories	Activity examples
Internal fraud	Losses due to acts of a type intended to defraud, misappropriate property or circumvent regulations, the law or company policy, excluding diversity/ discrimination events, which involves at least one internal party	Unauthorised activity	• Transactions not reported (intentional) • Transaction type unauthorised (with monetary loss) • Mismarking of position (intentional)
		Theft and fraud	• Fraud / credit fraud / worthless deposits • Theft / extortion / embezzlement / robbery • Misappropriation of assets • Malicious destruction of assets • Forgery • Check kiting • Smuggling • Account takeover / impersonation etc • Tax non-compliance / evasion (wilful) • Bribes / kickbacks • Insider trading (not on firm's account)
External fraud	Losses due to acts of a type intended to defraud, misappropriate property or circumvent the law, by a third party	Theft and fraud	• Theft / robbery • Forgery • Check kiting
		Systems security	• Hacking damage • Theft of information (with monetary loss)
Employment practices and workplace safety	Losses arising from acts inconsistent with employment, health or safety laws or agreements, from payment of personal injury	Employee relations	• Compensation, benefit, termination issues • Organised labour activity
		Safe environment	• General liability (slip and fall etc) • Employee health and safety rules events

Event-type category	Description	Categories	Activity examples
	claims, or from diversity / discrimination events		Workers compensation
		Diversity and discrimination	All discrimination types
Clients, products and business practices	Losses arising from an unintentional or negligent failure to meet a professional obligation to specific clients (including fiduciary and suitability requirements), or from the nature or design of a product.	Suitability, disclosure and fiduciary	- Fiduciary breaches / guideline violations - Suitability / disclosure issues (know-your-customer etc) - Retail customer disclosure violations - Breach of privacy - Aggressive sales - Account churning - Misuse of confidential information - Lender liability
		Improper business or market practices	- Antitrust - Improper trade / market practices - Market manipulation - Insider trading (on firm's account) - Unlicensed activity - Money laundering
		Product flaws	- Product defects (unauthorised etc) - Model errors
		Selection, sponsorship and exposure	- Failure to investigate client per guidelines - Exceeding client exposure limits
		Advisory activities	Disputes over performance of advisory activities

Event-type category	Description	Categories	Activity examples
Damage to physical assets	Losses arising from loss or damage to physical assets from natural disaster or other events	Disasters and other events	• Natural disaster losses • Human losses from external sources (terrorism, vandalism)
Business disruption and system failures	Losses arising from disruption of business or system failures	Systems	• Hardware • Software • Telecommunications • Utility outage / disruptions
Execution, delivery and process management	Losses from failed transaction processing or process management, from relations with trade counterparties and vendors	Transaction capture, execution and maintenance	• Miscommunication • Data entry, maintenance or loading error • Missed deadline or responsibility • Model / system misoperation • Accounting error / entity attribution error • Other task misperformance • Delivery failure • Collateral management failure • Reference data maintenance
		Monitoring and reporting	• Failed mandatory reporting obligation • Inaccurate external report (loss incurred)
		Customer intake and documentation	• Client permissions / disclaimers missing • Legal documents missing / incomplete
		Customer / client account management	• Unapproved access given to accounts • Incorrect client records (loss incurred) • Negligent loss or damage of client assets
		Trade counterparties	• Non-client counterparty misperformance • Miscellaneous non-client counterparty disputes
		Vendors and suppliers	• Outsourcing • Vendor disputes

Table D – Information required to be maintained for an operational loss event

Information	Narratives	Basel Framework reference
1. Reference dates	The following dates in respect of an operational loss event: (a) the date when the event happened or first began where available (“date of occurrence”); (b) the date when the AI became aware of the event (“date of discovery”); and (c) the date (or dates) when a loss event results in a loss, reserve or provision against a loss being recognised in the AI’s P&L accounts or for losses related to legal events, the date when a legal reserve is established for the probable estimated loss in the P&L accounts (“date of accounting”).	OPE25.19 (and also OPE25.28 for “date of accounting”)
2. Drivers or causes	Descriptive information of the drivers or causes of a loss event, the level of detail of which should be commensurate with the size of the gross loss amount of the event.	OPE25.19
3. Gross loss amount	Gross loss amount must include in its computation: (a) direct charges, including impairments and settlements, to the AI’s P&L accounts and write-downs due to an operational loss event; (b) costs incurred as a consequence of an operational loss event including external expenses with a direct link to the event (e.g. legal expenses directly related to the event and fees paid to advisors, attorneys or suppliers) and costs of repair or replacement, incurred to restore the position that was prevailing before the event; (c) provisions or reserves accounted for in the P&L accounts against a potential operational loss; (d) losses stemming from an operational loss event which are temporarily booked in transitory and/or suspense accounts and are not yet reflected in the P&L accounts (“pending losses”). Any material pending loss (i.e. that exceeds HK\$200,000) should be included in the loss data set within a time period commensurate with the size and age of the pending item; and (e) negative economic impacts booked in a financial accounting period due to an operational loss event impacting the cash flows or financial statements of previous	OPE25.24, 25.25, 25.26 and 25.27 With reference to item 12(5) of proposed BCR amendments, an AI should compute the “gross loss amount” of an operational event according to the Narratives.

Information	Narratives	Basel Framework reference
	financial accounting periods (“timing losses”). Any material timing loss (i.e. that exceeds HK\$200,000) should be included in the loss data set when it is due to the event that spans more than one financial accounting period and gives rise to legal risk. but must exclude: (a) costs of general maintenance contracts on property, plant or equipment; (b) internal or external expenditures to enhance the business after the operational risk losses: upgrades, improvements, risk assessment initiatives and enhancements; and (c) insurance premiums.	
4. Operational risk loss	Operational risk loss is the gross loss amount net of recoveries.	OPE25.24
5. Recoveries of gross loss amount	A recovery in relation to an operational loss event means, subsequent to a loss being recognized, the occurrence of funds or inflows of economic benefits received from a third party. Recoveries should be divided into non-insurance recoveries and insurance recoveries. Only payment received (as opposed to receivables) can be counted as recoveries. Tax effects, which refer to the benefit of deferred tax liability or reductions in corporate income tax liability due to operational losses, should also be excluded.	OPE25.24, 25.25 and 25.19 (FN4)

Table E – Exclusion of loss data from LC calculation

Reference in proposed BCR amendments	Particulars	Basel Framework reference
Item 13(1)(a)	The threshold for excluding the losses from an operational loss event from the calculation of the LC is HK\$200,000, consistent with item (4) of <u>Table B</u> .	OPE25.18
Item 13(2)	The MA will consider it prudent to exclude the losses arising from an event from the calculation of the LC if the following conditions are met: (a) the institution proves to the satisfaction of the MA that the event is no longer relevant to the institution's risk profile; (b) the cumulative losses after deduction of recoveries arising from the event over the calculation period exceeds 5% of the arithmetic mean of annual operational risk losses over the same period; and (c) the losses arising from the event have been included in the calculation of the annual operational risk losses for a period of at least 3 years. (This does not apply to an event occurred in businesses or activities divested by the institution.)	OPE25.30 and 25.32