NEVIS FINANCIAL SERVICES DEPARTMENT

MODULE 3

Guidance to completing the Operational Risk module of BSL/2

Operational Risk

Section 1 – Introduction

This module relates to reporting operational risk by banks licensed under the Nevis International Banking Ordinance, 2014 and incorporated under the Companies Ordinance under the Operational Risk module of the BSL/2 return. "Basel II" is the revised international capital framework set out by the Basel Committee on Banking Supervision in its paper "International Convergence of Capital Measurement and Capital Standards: A Revised Framework - Comprehensive Version", published in June 2006 (" the Basel II document").

Operational risk is defined in the Basel II document as the risk of loss resulting from:

- inadequate or failed internal processes and systems
- the actions of people; or
- external events.

The Basel II document states that this definition includes legal risk, but excludes strategic and reputational risk.

The Basic Indicator Approach ("BIA") is used to calculate the operational risk capital requirement.

This approaches has an associated reporting form in the module that must be used to derive the operational risk capital requirement, a calculation based on income data from the past three years.

The operational risk module of form BSL/2 is only to be completed by banks operating as subsidiaries in Nevis. Licensed branches should not complete this module.

Section 2 – Definition of Year of Operation

Under the BIA, the bank's capital charge for operational risk is calculated using gross income data from the last three years.

Year one is the last completed accounting year, years two and three are the two immediately preceding accounting years.

The Risk Weighted Assets ("RWA") "equivalent amount" is derived by multiplying the capital charge by 12.5, as established in Basel II. This is combined with the RWA derived for credit risk and other risks to arrive at the total RWA of the bank.

A bank should treat any partial year of operation of six months or more as a full year. Any partial year of operation of less than six months should be disregarded. If any partial year is counted as a full year, the gross income of that partial year should be annualised.

An illustration of calculating the gross income and advances in the retail and commercial banking business lines for partial and full years of operation is shown in **annex A**.

Section 3 – Guidance on Form Completion

General layout

A completed example of the form is included in ***annex B***.

Form 1.1 Basic Indicator Approach

The capital charge for operational risk under the BIA is calculated as 15% (denoted "Alpha") of the average gross income over the past three years, ignoring those years where income was not positive.

Section B: Gross Income comprising:

Item	Item Name	Definition
B.1	Net Interest Income	*Interest income net of interest expenses, for each of the three preceding years, gross of any provisions (e.g. for unpaid interest).*
B.2	Net Non-Interest Income	*Net non-interest income for each of the three preceding years. Note that this is gross of provisions and gross of operating expenses (including fees paid to outsourcing service providers) and should exclude realised profits/losses from the sale of securities in the banking book and extraordinary or irregular items as well as income derived from insurance.*

Section C: BIA Calculation

“Average Income” is calculated as the sum of the two items, shown in section B, for each year where the said sum was positive, divided by the number of those years.

Section D: BIA Requirement

The capital charge for the BIA is calculated as 15% of Average Income. The RWA equivalent for the BIA is calculated by multiplying the capital charge by 12.5.

Annex A – Examples of Full and Partial Year Treatments

Example 1: Three or more full years

If a bank:

- Had an accounting year that matched the calendar year;
- Had commenced operations prior to 1/1/2006; and
- Wished to report for Q4 2008, or any of the first three quarters in 2009, then:

"Last Year" would be 2008: report full year's gross income.

"1 year prior" would be 2007: derived in equivalent fashion to "Last Year".

"2 years prior" would be 2006.

Example 2: One full year plus one year of more than six months duration

If a bank:

- Had an accounting year that matched the calendar year;
- Had commenced operations on 1/4/2007; and
- Wished to report for Q4 2008, or any of the first three quarters in 2009, then:

"Last Year" would be 2008: report full year's gross income.

"1 year prior" would be 2007: annualise this partial year's gross income; in this case by dividing by nine (number of months of operation) and multiplying by twelve, and, only for the ASA, report the average of advances reported at end Q2, Q3 and Q4 2007.

"2 years prior" would be 2006: report zero for gross income. The calculation disregards these figures.

Example 3: Two full years plus one year of less than 6 months duration

If a bank:

- Had an accounting year that matched the calendar year;
- Had commenced operations on 1/9/2006; and
- Wished to report for Q4 2008, or any of the first three quarters in 2009, then:

"Last Year" would be 2008: report full year's gross income.

"1 year prior" would be 2007: derived in equivalent fashion to "Last Year".

"2 years prior" would be 2006: report zero for gross income. The calculation disregards these figures.

Annex B – Completion Example

Introduction

The example data given in the tables below has been used to complete the forms overleaf for illustrative purposes.

Gross Income

	2008		**2007**		**2006**	
Business Line	**Net Interest Income**	**Net Non-Interest Income**	**Net Interest Income**	**Net Non-Interest Income**	**Net Interest Income**	**Net Non-Interest Income**
Corporate Finance	0	1,200	0	1,100	0	1,000
Trading & Sales	0	2,000	0	-1,000	0	0
Retail Banking	5,000	-1,000	5,500	-1,000	6,000	-1,000
Commercial Banking	1,000	-2,000	-1,000	-3,000	0	0
Payment & Settlement	0	300	0	150	0	200
Agency Services	0	55	0	45	0	50
Asset Management	0	1000	0	-500	0	0
Retail Brokerage	0	1500	0	-500	0	0

Loans and Advances

Business Line	**2008**	**2007**	**2006**
Retail	80,000	90,000	100,000
Commercial	80,000	40,000	0

Completed Forms

MODULE 3

BASIC INDICATOR APPROACH OPERATIONAL RISK ("BIA")

Item	Nature of Item	Value
A	**BIA as agreed approach?**	YES

Item	Nature of Item	Last year	1 year prior	2 years prior
B	**Gross Income comprising:**			
B.1	Net Interest Income	6,000	4,500	6,000
B.2	Net Non-Interest Income	3,055	(4,705)	250
	TOTAL	**9,055**	**(205)**	**6,250**

Item	Nature of Item	Value
C	**BIA Calculation**	
C.1	Average Income, where positive	**7,653**
C.2	Alpha	**15%**

Item	Nature of Item	Capital Charge	RWA Equivalent
D	**BIA Requirement**	**1,148**	**1,450**