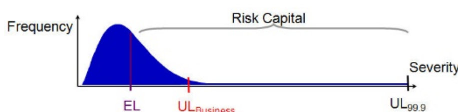
# Capital Management Service

For any company to function and succeed in achieving its strategic objectives, it requires access to capital, funds invested into the firm for its use, but on which the investors expect a return. This expected rate of return is often considered as a "*hurdle rate*", the minimum return which the firm can earn on its business activities to satisfy its investors. Management is then expected to earn a greater return if they wish to share in the proceeds or if they wish to grow the company further. This capital is also often referred to as the "*economic capital*" of the firm, the capital available for investing into the business' core activities.

Where management are either risk adverse or risk sensitive, they may set aside a portion of the capital available to them as a form of "*capital reserve*", that is, an amount of funds often invested in long-term, low-risk, low-return investments, but which the firm can access and draw upon in the event of an emergency. In certain industries, particularly those where firms have fiduciary responsibilities towards their customers and clients, such as within the broader financial services industry and specifically in the areas of banking, asset management and the various forms of insurance, regulatory authorities mandate each firm maintaining an adequate level of capital reserves.

Within the financial services sector, driven by the Basel Committee on Banking Supervision and the Solvency/Capital Requirements Directives, firms are required to calculate and maintain a level of what is termed "regulatory capital", a form of capital reserves set aside specifically to address specific risk types, such as credit risk, market risk and operational risk. While the approaches to the calculation of regulatory capital for credit and market risk have been in use for many years, this is not the case with operational risk, which is a relative newcomer to the regulatory capital environment.

Estimating how much capital a firm should hold to protect itself, its stakeholders and its clients from infrequent relatively significant operational losses is no trivial task, especially given the behavioural causal basis of operational risk, resulting in concepts such as "*black swans*" and "*unknown unknowns*" entering the operational risk glossary. Moreover, in addition to firms being expected to calculate the required amounts of operational risk regulatory capital they should hold, regulators also expect to see how the same firms then use or apply that capital to its business activities, so as to incentivise "*good*" or "*appropriate*" operational risk behaviour and conduct.




Firms have traditionally been allowed two approaches to operational risk regulatory capital estimation, one approach which uses simplistic measures as proxies for operational risk exposure and the other which involves the use of supposedly sophisticated statistical models to calculate the actual exposure to operational risk. While the insurance and asset management sectors have lagged behind the banking sector in implementing such models, after some 8 to 10 years experience with such models in the banking sector, the regulatory community is now reviewing whether or not to continue to employ modelling as a means for determining the appropriate levels of operational risk capital.

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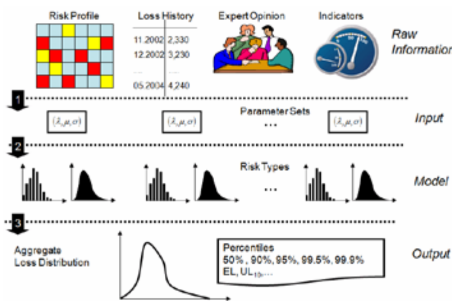
Within the banking sector, the simplistic approaches to regulatory capital estimation have usually relied upon the application of a pre-defined measure (an alpha or beta) to some measure of the firm's risk, performance or capacity, often represented by gross income. Under the Basic Indicator Approach (BIA), The Standardised Approach (TSA) and the Alternative Standardised Approach (ASA), the average annualised gross income for the three preceding years is used, with the BIA applying an alpha of 15%, the TSA and ASA dividing gross income by business activity and then using a beta ranging between 12% and 18% to reflect different riskiness of different business, while the ASA also allows certain changes in the calculation of gross income. These three approaches are now being replaced with the Revised Standardised Approach (RSA), which sees a three step approach to estimating the exposure of the firm and to which a business indicator will be applied.




The Risk*Business* Capital Management Service currently supports the calculation of BIA, TSA and ASA capital for the firm, including under the TSA and ASA approaches, calculation at a business line level. Once the requirements of the RSA are finalised, this approach will also be supported by the Capital Management Service. Given the wide differences in advanced modelling approaches, the Risk*Business* Capital Management Service does not itself directly support an Advanced Measurement Approach (AMA) model, however provides both the export capabilities to such models and the facility to import calculated values back from such a model. However, the Risk*IntelliSet*™ supports an external hybrid measurement model developed by Cirano, a Risk*Business* business partner, which can be deployed seamlessly as part of the Risk*Business* Capital Management Service.

Once operational risk capital values have been calculated and are available within the Risk*Business* Capital Management Service, facility is then available to allocate capital in an controlled and audited manner across the organisation. Options are available to create "scorecards" which take into account risk assessment data, KRI values, scenario assessments, qualitative management assessments, compliance to attestation requirements, etc., then to rank all participating entities against each other using these values, with the option for management determined bonus/malus add-ons, then to apply the capital amounts against the allocation model, allocating the resulting capital amounts to the individual businesses. The option to retain a portion of the capital at the centre and not to allocate that portion is also supported.

Allocations can be subject to specific authorisation requirements and are recorded in audit trails as evidence of allocation. Notification of allocation can be automatically generated to nominated business managers if required, while journal entries can optionally be generated from the Risk*IntelliSet*™ into the firm's general ledger.

For more information on the Capital Management Service, please contact Risk*Business* Services Limited through our website or email us at info@Risk*Business*.com.

Risk*Business* Services Limited
www.Risk*Business*.com
2 Claremont Way, Halesowen
West Midlands B63 4UR, UNITED KINGDOM