Eidgenössische Finanzmarktaufsicht FINMA
Autorité fédérale de surveillance des marchés financiers FINMA
Autorità federale di vigilanza sui mercati finanziari FINMA
Swiss Financial Market Supervisory Authority FINMA

FINMA Guidance 07/2024

Calculation of minimum capital for operational risks: exclusion of loss events

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Contents

1 Introduction

From 1 January 2025, minimum capital requirements for operational risks will be calculated in accordance with the Capital Adequacy Ordinance of 1 June 2012 (CAO; SR *952.03*) and the FINMA Ordinance of 6 March 2024 on the Leverage Ratio and Operational Risks of Banks and Securities Firms (LROO-FINMA; SR *952.033.11*). These two ordinances contain requirements and implementing provisions for the standardised approach for calculating minimum capital requirements for operational risks and, in particular, for the business indicator, business indicator component, internal loss multiplier and loss component.

Banks may exclude loss events that are no longer relevant from the calculation of the loss component if certain requirements are met (Art. 93*a* paras. 3 and 4 CAO).

This guidance sets out these requirements and examples and refers to the relevant implementing provisions from the explanatory notes to the final Basel III standards.[1]

2 Exclusion of loss events

All losses that are no longer incurred within the ten-year period pursuant to Article 93 para. 1 let. b CAO are excluded. For losses that are still within the ten-year period to be excluded, the allocated loss events must fulfil the requirements of Article 93*a* paras. 3 and 4 CAO and Article 30 LROO-FINMA. An exclusion must be clearly justified and of an exceptional nature.

2.1 Requirements

Specifically, under Article 30 para. 1 LROO-FINMA, a loss event is no longer relevant for the bank's risk profile if:

- no further losses are expected from the facts underlying the loss event (in particular, no further legal risks exist), and
- a comparable event can no longer occur under the inherent risk profile of the bank.

The inherent risk profile of the bank corresponds to the risks to which the bank is exposed through its products, activities, processes and systems,

[1] Explanatory notes of 6 March 2024 on the final Basel III standards – FINMA ordinances, available at www.finma.ch > Documentation > Consultations and evaluations > Completed consultations > 2022 > Final Basel III standards – new FINMA ordinances (4.7.2022–25.10.2022)

without taking into account control and mitigation measures (see margin no. 4 of FINMA Circular 2023/1 “Operational risks and resilience – banks”).

When assessing the relevance of a loss event for the inherent risk profile of a bank, it must be considered whether the cause of the loss could lead to further losses in other areas of the bank’s business activities. For example, in the case of settled legal cases, the bank must demonstrate that there are no remaining or comparable legal risks for the bank.

Example of an inherent risk profile:

> Bank A conducts cross-border business activities and has to pay a fine following legal disputes in jurisdiction B. The resulting costs are recognised in a loss event. Bank A discontinues all business activities in jurisdiction B. At the same time, however, bank A continues its cross-border business activities in other jurisdictions.
>
> The requirements pursuant to Article 30 para. 1 let. a LROO-FINMA are fulfilled in this case by the discontinuation of the business activity. This means that no further losses are to be expected due to the discontinuation of cross-border business activities in jurisdiction B.
>
> However, in order to justify the exclusion of the loss event due to the fine in jurisdiction B, it must be ensured with regard to the inherent risk profile of the bank as a whole that a comparable event (i.e. a fine in another jurisdiction) can no longer occur. As bank A continues to conduct cross-border business activities with other jurisdictions, a comparable event (i.e. a fine in another jurisdiction) cannot be ruled out. The inherent risk therefore remains.
>
> As a result, the loss event in connection with the fine in jurisdiction B cannot be excluded from the calculation of the loss component. If bank A discontinues its cross-border business activities altogether, no further comparable events are to be expected either from the underlying facts (business activities in jurisdiction B) or from the inherent risk profile of the bank. Accordingly, the loss due to the fine in jurisdiction B can be excluded.

The focus should be placed in particular on the cause of the loss event. Certain causes are inherent and relevant to the inherent risk profile of a bank to such an extent that such loss events can only be excluded if substantial adjustments are made to the business model of the respective bank. One example of this is loss events caused by the sale of banking products or cross-border business activities. Therefore, the exclusion of loss events is generally the exception.

Furthermore, provisions for possible future claims arising from the loss event do not fulfil the requirements of Article 30 para. 1 let. a LROO-FINMA. It cannot be ruled out due to the existence or recognition of provisions that further losses may arise from the circumstances underlying the loss event.

Some further examples of indications of a change (but not necessarily a reduction) in the inherent risk profile:[2]

- A previously manual process is converted into a fully automated process, thus losses from this process due to human errors such as typing errors can no longer occur; however, if there are other manual processes in which human errors such as typing errors can occur, a justified exclusion is unlikely.
- Business activities are no longer continued or no new business activities are commenced (e.g. no more investment banking); however, if there are other comparable business activities, a justified exclusion is unlikely.
- Specific product offerings are discontinued entirely or no new products are offered (e.g. no longer offering residential mortgage-backed securities); however, if comparable product offerings exist (e.g. commercial mortgage-backed securities), a justified exclusion is unlikely.
- Introduction of new processes such as payment methods (e.g. using new FinTech solutions) that completely replace current processes (with loss events).
- Substantial changes in client onboarding (e.g. by video instead of in person) that completely replace current processes (with loss events).
- New outsourcing to external service providers or to a cloud, or cessation of outsourcing.
- New system landscape (e.g. complete replacement of several previously connected IT systems with one).

2.2 Timing of the exclusion of loss events

Loss events that are no longer relevant to the bank's risk profile can be excluded from the calculation of the loss component three years after the last loss was recognised. The period may be shortened if the bank no longer continues the business activity on which the loss is based or comparable business activities (Art. 30 para. 2 LROO-FINMA).

[2] No. 4.5.5.3 of the explanatory notes of 6 March 2024 on the final Basel III standards – FINMA ordinances, available at www.finma.ch > Documentation > Consultations and evaluations > Completed consultations > 2022 > Final Basel III standards – new FINMA ordinances (4.7.2022–25.10.2022)

Example:

> A loss event has arisen from cross-border business activities. If the bank completely discontinues cross-border business activities, the loss event can be excluded if it can be clearly attributed to this discontinued business activity due to its nature and no further losses can arise from this loss event. However, if the bank resumes cross-border business, corresponding loss events suffered in the past must be included again in the calculation of the loss component, provided they still fall within the ten-year period.

2.3 Threshold for the exclusion of loss events

In principle, the materiality threshold of 10% of the average annual loss is used to exclude loss events. The net loss of the loss event within the ten-year period must exceed 10% of the average of the calculated annual losses for the ten years (Art. 29 para. 2 in conjunction with para. 3 LROO-FINMA). Furthermore, all gross losses and loss reductions allocated to the loss event are excluded from the calculation of the annual loss relevant for the loss component (Art. 29 para. 3 LROO-FINMA).

Loss events that do not reach this materiality threshold of 10% are still taken into account in the calculation of the loss component.

The materiality threshold of 10% of the average annual loss does not apply to the exclusion of loss events from a discontinued business activity (Art. 93*a* para. 3 CAO).

2.4 Notification to FINMA

The assessment of a loss exclusion is at the discretion of the bank. However, the criteria for the exclusion of losses must be set strictly and applied consistently (see section 2.1). The decision and the assessment of the loss exclusion must be clearly justified and documented.

The exclusion of a loss event is an exception and must be reported to FINMA. In the notification to FINMA regarding the exclusion of a loss event, the bank must prove that the conditions are met (Art. 30 para. 3 LROO-FINMA, see section 2.1).

The notification to FINMA must be made six weeks before the loss event is excluded (Art. 30 para. 3 LROO-FINMA), i.e. for example on 15 November for the annual financial statements as at 31 December.

FINMA reviews the notification and contacts the bank within six weeks if the exclusion of the loss event does not fulfil regulatory requirements. If FINMA does not respond, the bank may apply the exclusion after six weeks from the date of notification to FINMA.