GUIDANCE NOTE ON COMPUTATION OF CAPITAL CHARGE FOR OPERATIONAL RISK FOR BANKS AND FINANCIAL INSTITUTIONS, 2023

BANK OF TANZANIA

I. INTRODUCTION

1. The Standardised Approach (SA) issued in December 2017 replaces all the existing four approaches included in the Basel II framework, that is, the Basic Indicator Approach, the Standardised Approach, the Alternative Standardised Approach, and the Advanced Measurement Approach.

2. Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk, but excludes strategic and reputational risk.

3. These guidelines address determination of minimum capital requirements for Operational risk in accordance with the standardised approach issued in December 2017.

II. THE STANDARDISED APPROACH

4. The standardised approach methodology is based on three components, namely:

   (i) **Business Indicator (BI)** which is a financial statement -based proxy for operational risk; second;

   (ii) **Business Indicator Component (BIC),** which is calculated by multiplying the BI by a set of regulatory determined marginal coefficients (α_i); and

   (iii) **Internal Loss Multiplier (ILM),** which is a scaling factor that is based on a bank´s average historical losses and the BIC.

5. The BI is a measure of bank´s or financial institution's income that assumes that operational risk increases with bank´s or financial institution's size. This indicator is a financial statement-based proxy for operational risk consisting of the following three elements, each calculated as the average over three years:

   (i) interest, leases, and dividend component (ILDC);

   (ii) the services component (SC); and

   (iii) the financial component (FC).

   Therefore, the BI is expressed as: $BI = ILDC_{Avg} + SC_{Avg} + FC_{Avg}$

6. Definition of elements of Business Indicator:

   (i) ILDC: Interest, lease and Dividend

   (a) Interest income, except for financial and operating lease

   (b) Interest expenses, except for financial and operating lease

   (c) Interest earning assets

   (d) Financial and operating lease income

   (e) Financial and operating lease expenses

   (f) Dividend income

   (ii) SC: Services

   (a) Fee and commission: income & expenses

   (b) Other operating income

   (c) Other operating expenses

   (iii) FC: Financial

   (a) Net profit (loss) on the trading book

   (b) Net profit (loss) on the banking book.

7. Business Indicator definitions

BI component	Income statement or balance sheet items	Description	Typical sub-items
Interest, lease and dividend	Interest income	Interest income from all financial assets and other interest income (includes interest income from financial and operating leases and profits from leased assets).	• Interest income from loans and advances, assets available for sale, assets held to maturity, trading assets, financial leases and operational leases Interest income from hedge accounting derivatives Other interest income Profits from leased asset. • Interest income from hedge accounting derivatives. • Other interest income. • Profits from leased assets.
	Interest earning assets (balance sheet item)	Total gross outstanding loans, advances, interest bearing securities (including government bonds), and lease assets measured at the end of each financial year	
	Dividend income	Dividend income from investments in stocks and funds not consolidated in the bank's financial statements, including dividend income from non-consolidated subsidiaries, associates and joint ventures.	
Services	Fee and commission income	Income received from providing advice and services. Includes income received by the bank as an outsourcer of financial 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 transactions; Payment services; Structured finance; Servicing of securitisations; Loan commitments and guarantees given; and foreign transactions
	Fee and commission expenses	Expenses paid for receiving advice and services. Includes outsourcing fees paid by the bank for the supply of financial services, but not outsourcing fees paid for the supply of non-financial services (eg logistical, IT, human resources)	Fee and commission expenses from Clearing and settlement; Custody; Servicing of securitizations; Loan commitments and guarantees received; and Foreign transactions
	Other operating income	Income from ordinary banking operations not included in other BI items but of similar nature (income from operating leases should be excluded)	• Rental income from investment properties. • Gains from non-current assets and disposal groups classified as held for sale not qualifying as discontinued operations (IFRS 5.37)
	Other operating expenses	Expenses and losses from ordinary	• Losses from non-current assets and disposal groups classified as held for

BI component	Income statement or balance sheet items	Description	Typical sub-items
		banking operations not included in other BI items but of similar nature and from operational loss events (expenses from operating leases should be excluded)	sale not qualifying as discontinued operations (IFRS 5.37) • Losses incurred as a consequence of operational loss events (eg fines, penalties, settlements, replacement cost of damaged assets), which have not been provisioned /reserved for in previous years. • Expenses related to establishing provisions /reserves for operational loss events.
Financial	Net profit (loss) on the trading book	• Net profit/loss on trading assets and trading liabilities (derivatives, debt securities, equity securities, loans and advances, short positions, other assets and liabilities). • Net profit/loss from hedge accounting. • Net profit/loss from exchange differences	
	Net profit (loss) on the banking book	• Net profit/loss on financial assets and liabilities measured at fair value through profit and loss. • Realised gains/losses on financial assets and liabilities not measured at fair value through profit and loss (loans and advances, assets available for sale, assets held to maturity, financial liabilities measured at amortised cost). • Net profit/loss from hedge accounting. • Net profit/loss from exchange differences	

8. BI elements are calculated using the formular below. In the formula, a bar above a term indicates that it is calculated as the average over three years: t, t-1 and t-2., and:[1]

$$\text{ILDC} = \overline{\text{Min [Abs (Interest Income -Interest Expense)}^{2}\text{; 2.25\% of Interest Earning Assets]}} + \overline{\text{Abs (Net Lease Income)}} + \overline{\text{Dividend Income}}$$

$$\text{SC} = \text{Max [}\overline{\text{Other Operating Income}}\text{; }\overline{\text{Other Operating Expense}}\text{] + Max [}\overline{\text{Fee Income}}\text{; }\overline{\text{Fee Expense}}\text{]}$$

$$\text{FC} = \overline{\text{Abs (Net P\&L Trading Book)}} + \overline{\text{Abs (Net P\&L Banking Book)}}$$

9. To calculate the BIC, the BI is multiplied by the marginal coefficients (α_i). The marginal coefficients increase with the size of the BI as shown in the Table below. Banks and financial institutions are divided into three buckets according to the size of their BI. For banks and financial institutions in bucket 1, capital is an increasing linear function of the BI and does not depend on internal losses. In bucket 1, the BIC is equal to BI x 12 percent. The marginal increase in the BIC resulting from a one-unit increase in the BI is 12 percent in bucket 1, 15

[1] The absolute value of net items (e.g., interest income – interest expense) should be calculated first year by year. Only after this year by year calculation should the average of the three years be calculated.

[2] The Absolute amount of Net Interest Income (Balances with Other Banks; Investment in Debt Securities; Interbank Loans Recevables; and Loans, Advance and Overdraft) is capped to 2.25% of Interest Bearing Assets.

percent in bucket 2, and 18 percent in bucket 3:

Bucket	BI range (in TZS Trillion)	BI marginal coefficients (α)
1	≤ 2.5	12%
2	$2.5 < BI \leq 7.5$	15%
3	> 7.5	18%

10. The Internal Loss Multiplier **(**ILM) is a function of the BIC and the loss component (LC). Banks that have experienced greater operational risk losses in the past are more likely to experience similar losses in the future. The loss component is calculated as the average of the internal operational risk losses of the previous 10 years multiplied by 15.

11. The ILM is equal to one where the loss and business indicator components are equal. Where the LC is greater than the BIC, the ILM is greater than one. That is, a bank or financial institution with losses that are high relative to its BIC is required to hold higher capital due to the incorporation of internal losses into the calculation methodology.

12. The Standard gives National authorities discretion not to implement the loss component. This means to set the ILM at 1 for all banks and financial institutions, that is, to set the operational risk requirement equal to the BIC for all banks and financial institutions. Given the high value of the BI ranges, all banks and financial institutions in Tanzania would be in bucket 1. In this regard, the Bank of Tanzania decided to exercise this discretion and accordingly the capital charge for operational risk would be a function of the BI Component only. Nevertheless, banks and financial institutions shall collect historical loss data emanating from the following operational risk events:

    (a) Internal and External Fraud;
    (b) Execution, delivery & Process Management;
    (c) Business disruption and system failures;
    (d) Damage to Physical Assets;
    (e) Clients, Products & Business Practices;
    (f) Employment practices and workplace safety.

13. Capital charge for operational risk shall be calculated by multiplying the BI by 12 percent.

III. GENERAL PROVISIONS

14. The conversion factor for converting capital charge for operational risk into notional rik weighted assets shall be 8.33 which is a reciprocal of 12 percent.

15. Banks and financial institutions shall submit to the Bank a report on capital charge for operational risk in the manner and frequency prescribed by the Bank.

16. In the same way as for credit risk and market risk, the capital requirements for operational risk shall apply on solo and consolidated basis.