

Operational risk part

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1 Application and definitions

1.1 This Part applies to a JIB.

1.2 In this Part, the following definitions shall apply:

Business Indicator

has the meaning given in 5.2.

Business Indicator Component

has the meaning given in 5.7.

Financial Component

means the items specified in the table C in Annex 1 of this Part, excluding any items specified in table D in Annex 1 of this Part.

Gross Loss

means loss before Recoveries of any type.

Interest, Leases and Dividend Component

means the items specified in table A in Annex 1 of this Part, excluding any items specified in table D in Annex 1 of this Part.

Internal Loss Multiplier

has the meaning given in 5.9.

Level 1 Supervisory Categories

means the event types specified in the first column of the table in Annex 2 of this Part.

Recoveries

means an independent occurrence which is related to the original loss event and separate in time in which funds or inflows of economic benefits are received from a third party (excluding receivables).

Services Component

means the items specified in the table B in Annex 1 of this Part, excluding any items specified in table D in Annex 1 of this Part.

Standardised Approach

means the approach to calculating operational risk which is set out in Chapter 5.

2 Level of application

- 2.1 A JIB must comply with this Part on the basis of its consolidated position, unless the JFSC has agreed a variance in accordance with the Risk-Based Capital Requirements Part.

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3 Organisational structure and control mechanisms

- 3.1 A JIB shall set up a proper organisational structure and appropriate Internal Control mechanisms in order to ensure that the data required for consolidation for the purposes of this Part are duly processed and forwarded.
- 3.2 A JIB shall ensure that a subsidiary not subject to this Part implements arrangements, processes and mechanisms to ensure proper consolidation for the purposes of this Part.

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4 Own funds requirements

- 4.1 A JIB must calculate its own funds requirement for operational risk in accordance with the Standardised Approach by multiplying the Business Indicator Component and the Internal Loss Multiplier.

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5 The standardised approach

General

5.1 The standardised approach comprises:

- (1) the Business Indicator;
- (2) the Business Indicator Component; and
- (3) the Internal Loss Multiplier.

Business Indicator

5.2 The Business Indicator is the sum of the following three components:

- (1) the Interest, Leases and Dividend Component;
- (2) the services component; and
- (3) the financial component,

which are to be calculated in accordance with the table at 5.3.

5.3 Table: calculation of the Business Indicator

Component	Formula
Interest, Leases and Dividend Component	$\overline{\text{Min}[\text{Abs}(\text{Interest Income} - \text{Interest Expense}); 2.25\% \times \text{Interest Earning Assets}] + \overline{\text{Dividend Income}}}$
services component	$\overline{\text{Max}[\text{Other Operating Income}; \text{Other Operating Expense}]} + \overline{\text{Max}[\text{Fee Income}; \text{Fee Expense}]}$
financial component	$\overline{\text{Abs}(\text{Net Profit and Loss Trading Book})} + \overline{\text{Abs}(\text{Net Profit and Loss Banking Book})}$

5.4 In the table at 5.3:

- (1) a bar above a term indicates that the value must be calculated as an average over the last three years, except that a JIB may use forward looking estimates where it has been in operation for less than three years;
- (2) the absolute value of net items must firstly be calculated year by year and after that calculation the average over the last three years must be calculated, except that a JIB may use forward looking estimates where it has been in operation for less than three years;
- (3) a JIB must use audited figures where they are available but may use business estimates where audited figures are not available;
- (4) at financial year end, the current financial year must be included in the calculation of the three-year average for the purposes of (1) and (2).

5.5 In calculating the Business Indicator:

- (1) subject to (2), a JIB must include any business acquisitions, mergers or disposals of

entities or activities which occurred during the three year period referred to in 5.4;

- (2) a JIB may apply to the JFSC for a variance to exclude business acquisitions, mergers or disposals of entities or activities which occurred during the three year period referred to in 5.4 where it can demonstrate that, due to an acquisition or merger, disposals of entities or activities, using the three year period referred to in 5.4 would lead to a biased estimation for the own funds requirement for operational risk.

Business Indicator Component

5.7 A JIB must calculate the Business Indicator Component by multiplying the Business Indicator by the applicable marginal coefficients set out in the table at 5.8.

5.8 Table: Business Indicator range and marginal coefficients

Bucket	Business Indicator range (GBP bn)	Business Indicator marginal coefficients
1	≤ 0.88	12%
2	$0.88 < \text{Business Indicator} \leq 26$	15%
3	> 26	18%

Internal Loss Multiplier

5.9 The Internal Loss Multiplier is equal to one.

6 Policies and processes

- 6.1 A JIB must establish, implement and maintain policies and processes to evaluate and manage its exposure to operational risk.
- 6.2 In establishing, implementing and maintaining policies and processes to evaluate and manage its exposure to operational risk a JIB must:
 - (1) have an independent risk management function for operational risk;
 - (2) ensure that its internal measurement system for operational risk is closely integrated into its day-to-day risk management processes and that the output is an integral part of the process of monitoring and controlling the JIB's operational risk profile;
 - (3) implement a system of reporting to senior management that provides operational risk reports to relevant functions within the JIB and procedures for taking appropriate action according to that information;
 - (4) implement an assessment and management system for operational risk which is well documented with clear responsibilities assigned for this system and practices for ensuring compliance and addressing non-compliance;
 - (5) conduct regular reviews of its operational risk management processes and measurement systems which are performed by internal or external auditors;
 - (6) ensure that internal validation processes for operational risk management operate in a sound and effective manner; and
 - (7) ensure that data flows and processes associated with its risk measurement system for operational risk are transparent and accessible.

7 Identification, collection and treatment of loss data

7.1 A JIB must identify, collect and treat internal loss data in accordance with the following general requirements:

- (1) it must have documented procedures and processes for the identification and collection of internal loss data which must be subject to regular independent reviews by internal and/or external audit functions;
- (2) it must base its internal loss data on an observation period of 10 years: in the event that reliable data is not available over a period of 10 years it may, exceptionally, be based on a shorter period of no less than five years;
- (3) it must map its historical internal loss data into the relevant Level 1 Supervisory Categories and document criteria for allocating losses to the specified event types consistently with the descriptions, categories and examples set out in the second, third and fourth columns of the table in Annex 2 of this Part;
- (4) its internal loss data must be comprehensive and capture all material activities and exposures from all appropriate subsystems and geographic locations: the minimum threshold for including a loss event in the data collection is GBP 20,000;
- (5) in addition to information on Gross Loss amounts, it must collect information about the reference dates of operational risk events including:
 - (a) the date when the event happened or first began, where available;
 - (b) the date on which the JIB became aware of the event; and
 - (c) the date (or dates) when a loss event results in a loss, reserve or provision against a loss being recognised in the JIB's profit and loss accounts;
- (6) in addition to (5), it must collect information on recoveries of Gross Loss amounts as well as descriptive information about the drivers or causes of the loss event: the level of detail of any descriptive information should be commensurate with the size of the Gross Loss amount;
- (7) operational loss events that relate to credit risk:
 - (a) must not be included in the loss data set where the event is accounted for in the risk-weighted exposure amount for credit risk; and
 - (b) must be included in the loss data set where the event is not accounted for in the risk-weighted exposure amount for credit risk;
- (8) operational risk losses related to market risk must be treated as operational risk losses; and
- (9) it must implement processes to independently review the comprehensiveness, accuracy and quality of loss data.

7.2 A JIB must identify, collect and treat internal loss data in accordance with the following specific requirements:

- (1) it must be able to identify the Gross Loss amounts, non-insurance Recoveries, and

- insurance Recoveries for all operational loss events;
- (2) it must use losses net of Recoveries (including insurance Recoveries) in the loss dataset and may only use Recoveries to reduce losses after the JIB receives payment;
 - (3) it must provide the JFSC with information which verifies the receipt of payments used to reduce losses if requested by the JFSC;
 - (4) it must include the following items in the Gross Loss computation of the loss data set:
 - (a) direct charges (including impairments and settlements) to the JIB's profit and loss accounts and write-downs due to the operational risk event;
 - (b) costs incurred as a consequence of the operational risk event including external expenses with a direct link to the event (such as legal expenses directly related to the event and fees paid to advisors or suppliers) and costs of repair or replacement incurred to restore the position that was prevailing before the operational risk event;
 - (c) provisions or reserves accounted for in the profit and loss account against the potential operational loss impact;
 - (d) losses stemming from operational risk events with a definitive financial impact which are temporarily booked in transitory and/or suspense accounts and are not yet reflected in the profit and loss account: material losses in this category must 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 operational risk events impacting the cash-flows or financial statements of previous financial accounting periods: material losses in this category must be included in the loss data set when they are due to operational risk events that span more than one financial accounting period;
 - (5) it must exclude the following items from the Gross Loss computation of the loss data set:
 - (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 (including upgrades, improvements, risk assessment initiatives and enhancements); and
 - (c) insurance premiums;
 - (6) in relation to accounting dates:
 - (a) it must use the date of accounting for building the loss data set;
 - (b) it must use the date of accounting for including losses related to legal events in the loss data set and for such events the date of accounting is the date when a legal reserve is established for the probable estimated loss in the profit and loss account; and
 - (c) it must allocate losses caused by a common operational risk event, or by related operational risk events over time but posted to the accounts over several years, to the corresponding years of the loss database in line with their accounting treatment.

Annex 1 – Business Indicator components

Table A: items to be included in the Interest, Leases and Dividend Component

Items	Description	Sub items
Interest income	Interest income from all financial assets and other interest income	Interest income
	Profits from leased assets	Operating leases other than investment property
Interest expense	Interest expenses from all financial liabilities and other interest expenses	Interest expense
	Losses from leased assets and depreciation and impairment of operating leased assets	Operating leases other than investment property
Interest earning assets	Total gross outstanding loans, advances, interest-bearing securities (including government bonds) and lease assets measured at the end of the financial year	Cash, cash balances at central banks and other demand deposits
		Financial assets held for trading
		Non-trading financial assets mandatorily at fair value through profit or loss
		Financial assets designated at fair value through profit or loss
		Financial assets at fair value through other comprehensive income
		Financial assets at amortised cost
		Derivatives – hedge accounting
		Tangible and intangible assets: assets subject to operating lease
Dividend income	Dividend income from investments in stocks and funds not consolidated in the JIB's financial statements, including dividend income from non-consolidated subsidiaries, associates and joint ventures	Dividend incomes

Table B: items to be included in the Services Component

Items	Description	Sub items
Fee and commission income	Income received from providing advice and services. Includes income received by the JIB as an outsourcer of financial services	Fee and commission income
Fee and commission expense	Expense paid for receiving advice and services. Includes outsourcing fees paid by the JIB for the supply of financial services but not outsourcing fees paid for the supply of non-financial services	Fee and commission expense
Other operating income	Income from ordinary banking operations not included in other Business Indicator items but of a similar nature (income from operating leases should be excluded)	Other operating income
		MINUS Operating leases other than investment property
		Profit from non-current assets and disposal groups classified as held for sale not qualifying as discontinued operations
Other operating expense	Expenses and losses from ordinary banking operations not included in other Business Indicator items but of a similar nature and from operational loss events (expenses from operating leases should be excluded)	Other operating expense
		MINUS Operating leases other than investment property
		Expenses related to establishing provisions/reserves for operational loss events: new additions including increases in existing provisions
		MINUS Expenses related to establishing provisions/reserves for operational loss events: unused amounts reversed during the period
		Losses from non-current assets and disposal groups classified as held for sale not qualifying as discontinued operations

Table C: items to be included in the Financial Component

Items	Description	Sub items
Net trading (loss) on trading book	Net profit (loss) on trading book	Gains or (-) losses on financial assets and liabilities held for trading, net
Net profit (loss) on banking book	Realised gains/losses on financial assets and liabilities not measured at fair value through profit and loss	Gains or (-) losses on de-recognition of financial assets and liabilities not measured at fair value through profit or loss, net
	Net profit/loss on financial assets and liabilities measured at fair value through profit and loss	Gains or (-) losses on non-trading financial assets mandatorily at fair value through profit or loss, net
		Gains or (-) losses on financial assets and liabilities designated at fair value through profit or loss, net
	Net profit/loss from hedge accounting	Gains or (-) losses from hedge accounting, net
	Net profit/loss from exchange differences	Exchange differences (gain or (-) loss), net

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Table D: items which do not contribute to any components of the Business Indicator

Income and expenses from insurance or reinsurance businesses
Premiums paid and reimbursements/payments received from insurance or reinsurance policies purchased
Administrative expenses including staff expenses, outsourcing fees paid for the supply of non-financial services (for example logistical, IT, human resources), and other administrative expenses (for example IT, utilities, telephone, travel, office supplies, postage)
Recovery of administrative expenses including recovery of payments on behalf of customers (for example taxes debited to customers)
Expenses of premises and fixed assets (except when these expenses result from operational loss events)
Depreciation/amortisation of tangible and intangible assets (except depreciation related to operating lease assets, which should be included in financial and operating lease expenses)
Provisions/reversal of provisions (for example on pensions, commitments and guarantees given) except for provisions related to operational loss events
Expenses due to share capital repayable on demand
Impairment/reversal of impairment (for example on financial assets, non-financial assets, investments in subsidiaries, joint ventures and associates)
Changes in goodwill recognised in profit or loss
Corporate income tax (tax based on profits including current tax and deferred)

Annex 2 – Detailed loss event type classification

Event-type category (Level 1)	Description	Categories (Level 2)	Activity examples (Level 3)
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 JIB'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 claims, or from diversity/discrimination events	Employee relations	Compensation, benefit, termination issues Organised labour activity
		Safe environment	General liability (slip and fall etc.) Employee health and safety rules events Workers compensation
		Diversity and discrimination	All discrimination types

Event-type category (Level 1)	Description	Categories (Level 2)	Activity examples (Level 3)
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 JIB'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
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

Event-type category (Level 1)	Description	Categories (Level 2)	Activity examples (Level 3)
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	<p>Miscommunication</p> <p>Data entry, maintenance or loading error</p> <p>Missed deadline or responsibility</p> <p>Model/system mis-operation</p> <p>Accounting error/entity attribution error</p> <p>Other task mis-performance Delivery failure</p> <p>Collateral management failure</p> <p>Reference data maintenance</p>
		Monitoring and reporting	<p>Failed mandatory reporting obligation</p> <p>Inaccurate external report (loss incurred)</p>
		Customer intake and documentation	<p>Client permissions/disclaimers missing</p> <p>Legal documents missing/incomplete</p>
		Customer/client account management	<p>Unapproved access given to accounts</p> <p>Incorrect client records (loss incurred)</p> <p>Negligent loss or damage of client assets</p>
		Trade counterparties	<p>Non-client counterparty mis-performance</p> <p>Miscellaneous non-client counterparty disputes</p>
		Vendors and suppliers	<p>Outsourcing</p> <p>Vendor disputes</p>