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Between Policy and Practice: Basel III Operational Risk Implementation in Peshawar's Commercial Bank Branches

Shahbaz Khan Yousaf Zai

Institute of Management Sciences, Peshawar

Amir Zeb*

Institute of Management Sciences, Peshawar

*Corresponding author: Amir Zeb — amirzeb617@gmail.com

Junaid Ahmad

Institute of Management Sciences, Peshawar

Abstract

This study explores the awareness of Basel III operational risk requirements and operational risk control practices of commercial banks at branch level and implementation selection at the institution level in Peshawar city of Pakistan. The study has a descriptive, mixed-methods design that triangulates the findings from semi-structured interviews with ten bank branch/operations managers against the published annual reports and disclosures of the corresponding banks, and examines three interrelated questions: how much do bank branch-level staff know about Basel III operational risk requirements; what operational risk controls are actually followed at branch level; and which approach to capital-measurement for operational risk does each bank take. The interviews show that Basel III was poorly understood with only 2 out of 10 respondents being able to accurately explain Basel III operational risk requirements; the rest of the respondents explained their actions as compliance with internal bank policies, rather than to Basel III. Institutional level, the annual report disclosures indicate that 10 of 10 sample banks have implemented a Basel III framework for measuring capital adequacy and market risk, with 5 of 10 banks continuing to use the Basic Indicator Approach (BIA) for measuring operational risk instead of the more risk-sensitive Alternative Standardized Approach (ASA), and 2 banks reporting Basel III applicability without full implementation. In spite of this lack of regulatory knowledge, the operational controls actually employed at the branch level are very similar to the sound principles of operational risk management set out by the Basel Committee on Banking Supervision (BCBS, 2014). Basel-specific training was also found to be very limited, with awareness about Basel being created by the operating procedures issued by the branch managers, which are aligned with the Basel principles, instead of through the Basel literacy programmes. The study suggests that this trend is a reflection of a disconnect between operational compliance and regulatory literacy and offers guidance to supervisors and banks in emerging markets in designing operational risk training and communicating regulatory frameworks to the branch level.

Keywords: Alternative Standardized Approach; bank branch management; Basel III; Basic Indicator Approach; operational risk; Pakistan; Peshawar; regulatory awareness

1. Introduction

1.1 The Basel Framework and Operational Risk

The Basel Accords is the main international regulatory framework for the Basel Committee on Banking Supervision (BCBS) to establish minimum capital and risk-management standards for banks, encompassing credit risk, market risk, and operational risk. They are designed to make sure that financial institutions have enough capital to withstand unplanned losses, and stay solvent during financial stress (Al-Tamimi, 2008). The BCBS was established in 1974 as a forum for cooperation between the supervisors of the G10 banks, following the collapse of Bankhaus Herstatt and Franklin National Bank; the first accord, Basel I, was signed in 1988 under the auspices of the BIS, whose main objective was to protect international banking systems from financial crises by establishing minimum capital requirements (Makwiramiti, 2008; BIS, 2008).

The original Basel accord was expanded in the early 2000s to become Basel II, which introduced three new pillars: minimum capital requirements, supervisory review, and market discipline, and, for the first time, mandated that banks maintain capital that is specific to operational risk as well as credit and market risk (BCBS, 2006). The 2007-2008 global financial crisis revealed that there were weaknesses in this framework: Sabato (2010) stated that poor governance, weak risk management, inappropriate incentive structures, and excessive leverage across the banking industry had compounded the crisis. Basel III was introduced in 2010, however, to enhance the Basel II framework, rather than replace it, mainly on the liabilities side of the balance sheet, with higher capital ratios, a new common-equity requirement, higher counterparty risk charges and strengthened risk governance and disclosure.

The Basel Accords were designed for the G10 countries but were supposed to be applied to all countries, including the developing countries, because capital adequacy must be commensurate with the riskiness of a bank's assets, irrespective of the country where they are located (Mboweni, 2004). The implementation of the Basel framework is generally seen as crucial to good risk management in banking systems (Subcommittee, 2004; Carauna, 2004).

1.2 Pakistan's Banking Sector and the Case for a Peshawar-Based Study

In Pakistan, the State Bank of Pakistan (SBP) under the Ministry of Finance, has been given the statutory duty of supervising the banking sector. The sector has experienced significant structural transformation over the last two decades, transitioning from being a highly state-owned to a highly privatised sector, and the top five banks by assets such as Habib Bank Limited, Muslim Commercial Bank, National Bank of Pakistan, United Bank Limited and Allied Bank Limited are now active in international markets including Europe, Americas and China. The retail banking sector has also been diversified with the introduction of branchless banking and mobile money services (JazzCash, EasyPaisa, UPaisa).

The banking system in Pakistan was sound at the time of this study. Gross advances to the private sector grew by about 10.6% year-on-year, while the capital adequacy ratio (CAR) remained at 16.17%, well above the minimum of 10.65%, as the return on assets (ROA) decreased from 2.5% to 2.1% and the net interest margin (NIM) fell from 4.4% to 3.7%, according to data from Business Recorder (2016). The total assets of the banking sector increased by 11.9% to Rs. The total value of investment holdings shrank by 1.5% to 15.831 trillion, but deposits were reduced in investment holdings due to the withdrawal of deposits from government securities. SBP's then deputy governor assured the public that Pakistani banks were moving towards Basel III capital

and liquidity norms, and assured support for banks facing challenges in meeting the new standards.

Although there is a policy push for Basel III, empirical evidence on the understanding and implementation of Basel III — and in particular the provisions on operational risk — at the branch level in Pakistan is limited, with most of the available commentaries focusing on national regulatory policy or head-office disclosure. The gap is significant because operational risk is created much more by the day-to-day actions of people, processes and systems within the bank, at the point of service delivery, than by actions taken at head office, at the portfolio level. The emphasis on operational risk in the Pakistani context is also driven by recent consolidation in the banking industry, specifically the merger of NIB Bank with MCB, and by the presence of international banks, which have added to the diversification and complexity of the banking industry in Pakistan. Peshawar, as the main urban banking hub of KP, provides an interesting and hitherto under-researched context to examine this dimension of the implementation of Basel III at the branch level.

1.3 Objectives, Research Questions, and Contribution

This study aims to achieve three objectives which are interlinked: (1) to test the level of awareness of branch level operations and branch managers about Basel operational risk requirement; (2) to document the existing level of operational risk management practices and controls at branch level; and (3) to identify from banks' annual report disclosure what operational risk measurement approach each sample bank has adopted under Basel III, either Basic Indicator or Standardized or Alternative Standardized approach. In a similar manner, three research questions have been formulated in the study: How is the Basel Accord applied in the banking sector of Pakistan? What is the level of awareness (knowledge) of the local branch management in Peshawar about operational risk as prescribed in the Basel documents and SBP circulars? What are the actions taken by the local branch management in Peshawar regarding operational risk issues and its management? The paper provides descriptive, branch level evidence of the link between formal regulatory awareness and actual risk-control behaviour, which is missing from the literature on Basel implementation, which tends to focus on capital ratios and institutional disclosure, but not on the knowledge and behaviour of front-line staff who implement the risk controls. The remainder of the paper is organised as follows. Section 2 provides a review of the Basel framework, the Basel II/III approach to operational risk, and the BCBS's sound principles of operational risk management. The methodology of the study is described in Section 3. The results of the interviews and an annual report review are reported in Section 4. The findings are discussed in the light of the BCBS principles in section 5, followed by theoretical implications, practical implications, limitations, future research directions and conclusions.

2. Literature Review

2.1 Basel I

Basel I, released in 1988, imposed a minimum capital requirement of 8% of risk-weighted assets and was eventually adopted by over 100 countries by 2005, largely to mitigate systemic risk after the financial instability of the 1970s, and to allow financial institutions to withstand general and credit losses (Dobson & Hufbauer, 2001; Rime, 2001; Cumming & Nel, 2005). Later, Ong (2004, as cited in Hai, Minnhaj & Ahmed, 2007) criticized it as a one size fits all solution that was inadequate in differentiating the various risks of bank operations. New financial products, growing globalisation and the globalisation of financial markets put pressure on the revision of

Basel I, especially in the sense of some banks using the relatively fine-grained risk categories to construct concentrated portfolios of high-risk assets within the individual categories (Cumming & Nel, 2005).

2.2 Basel II

Under Basel II, the framework was split into three pillars: minimum capital requirements, supervisory review, and market discipline (Bailey, 2005). The accord extended the definition of risk in Pillar I to explicitly cover operational risk as well as credit and market risk. Basel II provided two paths for measuring credit risk: The Standardized Approach (SA) and The Internal Ratings Based (IRB) approach, which gave banks the freedom to use their internal estimates of borrower creditworthiness, primarily the probability of default (PD), which could be subject to supervisory review, or, under the Advanced IRB variant, directly estimated (BCBS, 2006). Basel II had 3 measurement approaches for operational risk – namely, the Basic Indicator Approach, the Standardized Approach, and the Internal Measurement Approach. For market risk, which is caused by market price fluctuations on the balance sheet such as foreign exchange, commodity and interest rate risk, Basel II set minimum capital requirements and also gave guidelines on position valuation, independent price verification and reserve/valuation adjustments. Pillar II, supervisory review, mandated banks to have ongoing systems and processes for the assessment of capital adequacy and allowed supervisors to impose capital above and beyond the minimum of 8% required by Pillar I if they deem it necessary, as well as to intervene in the risk management process as needed (BCBS, n.d.). The market discipline portion of Pillar III aimed at enhancing transparency by introducing the requirement for the public disclosure of banks' risk profiles and capital adequacy, with the assumption that market participants will only be able to evaluate and discipline a bank's risk-taking behavior if the bank's reporting is sufficiently transparent (BCBS, 2001; BCBS, 2006). In principle, full disclosure enables those who play it safe with risk exposure in banks to be rewarded and those who play it loose to be punished (Makwiramiti, 2008). The advantages of Basel II have been broken down into organisational, loan level and portfolio level gains as well as other enhancements of regulatory frameworks and processes.

2.3 Basel III

After the financial crisis of 2008, and the identification of the main root causes of the crisis – namely, inadequate risk management, misaligned incentive structures, excessive leverage and weak governance within the banking sector, the BCBS took steps to develop a more robust accord. Basel III is not a replacement of Basel II, but it is an enhancement of Basel II, mainly on the liabilities side (capital and liquidity), while Basel II had been more focusing on the asset side. Basel III introduced new capital ratios, such as a new ratio based on common equity; higher capital charges for counterparty risk; and clarified the definitions of Tier 1 and Tier 2 capital. Its wider objectives were to enhance the capacity of the banking sector to withstand shocks from financial and economic stress, to bolster risk management and governance and to boost transparency and disclosure throughout the banking sector.

2.4 Operational Risk: Definition, Crisis Origins, and Measurement

Operational risk is defined by the BCBS as the risk of loss arising from inadequate or failed internal processes, people and systems, or from external events, although it does not mention reputational risk (BCBS, 2001). The BCBS stated that it would reconsider operational risk measurement when it reviews the capital adequacy framework after the financial crisis, particularly when it looks at minimum capital requirements for operational risk, which have been

stable – or even lower – despite a rise in the intensity of operational risk incidents during and after the financial crisis. The pattern indicated that the Basic Indicator Approach (BIA) and the Standardized Approach (SA), including its “Alternative Standardized Approach” (ASA) variant, might leave banks with lower operational risk capital requirements than they actually need (BCBS, 2014).

Operational risk has been proven to be central to the 2007-2008 crisis from various perspectives. Jorion (2001) views the "business" of financial corporations as risk management, and argues that banks, unlike other corporations, need risk management that is dynamic and constantly evolving. Sabato (2010) reasons that the failure to manage risks during the crisis is partly due to the implicit belief by major banks that they were “too big to fail” and could be relied upon to self-regulate, as well as the lack of clarity on their capital allocation process and inadequate internal governance. Similarly, in the financial sector, Andersen, Mabergh, Hägerwz and Næss (2012) name neglected market risk, credit risk, liquidity risk and operational risk management as a contributing cause in US and European financial institutions. Although there was some improvement in board-level risk management practices in the years immediately after the crisis, this increased in an uneven manner (Munro 2010) and Denning (2013) argues that the post-crisis regulatory reform in Europe failed to stop an increase in bank size and trading activity that had been characteristic of the pre-crisis era.

The 2007–2008 crisis was long and deep, and operational risk — not just its interaction with liquidity risk — had a significant impact on the crisis, as pointed out by Jongh and Van Vuuren (2013), which led to a greater focus on operational risk in the subsequent years by scholars and regulators. Operational risk is indeed one of the most challenging areas of risk management to quantify and assign a value for using traditional risk management tools, as described by Neville (2005). This is one reason why there is a persistent push by regulators for standardised measurement frameworks. While the BCBS doesn't mention reputation in its definition of operational risk, in practice, they write, operational failures can give rise to reputational consequences, which can add to the financial loss, as in the case of Banco Santander during the economic downturn they study.

2.5 BCBS Sound Principles of Operational Risk Management

The BCBS's Sound Principles of Operational Risk Management (2014) sets out eleven principles spanning governance and practice, summarised in Table 1.

Principle group	Principles	Core requirement
Governance foundation	1–5	Board-led risk culture; a Framework which is fully embedded in the bank's risk management, approved and reviewed by the board regularly; an approved risk appetite/tolerance statement which sets out the nature, types and extent of operational risk that the bank will tolerate; a well established, transparent and consistent structure of lines of responsibility at senior management level.
Operational practice	6–9	Appropriate identification and assessment of risk inherent in all material products, activities, processes and systems; a formal approval process for operational risk of all new activity, products, processes and systems; regular monitoring of

Principle group	Principles	Core requirement
		operational risk profiles and material exposures with appropriate reporting to the board, senior management and business lines; a strong control environment with appropriate internal controls, policies and procedures, and risk transfer and/or risk mitigation.
Resilience and transparency	10–11	Disclosure adequate to enable stakeholders to evaluate a bank's approach to operational risk management, with a view to business continuity and resiliency planning, which should allow the bank to continue operating and minimise losses in the event of a significant disruption to its business;

2.6 Three Lines of Defence

The BCBS (2014) outlines a three lines of defence framework for operational risk governance in addition to these principles. Business line management is the first line of defence and directly responsible for the risks associated with its products and processes. The second line of defence is provided by an independent corporate operational risk function (CORF) which questions and monitors the first line's risk management and measurement processes, the level of independence of which is commensurate with the size and complexity of the bank. The third line of defence is the independent review of the adequacy and effectiveness of controls, processes and systems, which is normally carried out internally or externally by staff who are not directly involved in the day-to-day operation of the controls, processes or systems.

2.7 Research Gap

The literature reviewed above provides a picture of the development of capital and operational risk requirements at the international standard-setting and institutional disclosure levels, and, in the literature following the crisis, at the level of board-level governance failure, but relatively little empirical research has focused on the understanding and application of these requirements by the branch-level staff who operate the day-to-day operational controls, especially in Pakistan where, as noted in Section 1.2, studies specifically examining Basel III implementation are limited. The existing literature on the implementation of Basel in Pakistan is largely descriptive of the national regulatory trends and not of the conduct of the branches. This study directly tackles this gap by exploring awareness, practice, and institutional implementation simultaneously in a single triangulated dataset.

3. Methodology

3.1 Research Design

The study is descriptive, cross-sectional research with qualitative and quantitative aspects. Descriptive research is used to answer the question, “what is?” rather than to test causal hypotheses, is organized, tabulated, and explained data collected from existing instances of awareness and practice as generated in the survey and interview data collection methods used here (Borg & Gall, 1989; Glass & Hopkins, 1984), and is well suited to this type of data collection. Data was collected at one time, as in a cross sectional design.

3.2 Sample

The target population was commercial banks in Pakistan and for feasibility, the banks were selected from Peshawar, which is the administrative and commercial hub of Khyber

Pakhtunkhwa. The sampling frame consisted of Peshawar and was sampled using simple random sampling method with an attempt to maintain proportional representation of the sampled institutions. The final sample included 10 (P1-P10) bank branches in Peshawar, one bank operations/branch manager was interviewed from each bank (Peshawar). The sample was comprised of conventional and Islamic bank branches.

3.3 Data Collection

Two types of data were utilized and triangulation between primary and secondary evidence was possible:

Primary data: Face to face and semi-structured interviews with operational/branch managers of each of the ten sample branches. Interviews were tape-recorded and then transcribed.

Secondary data: Audited annual reports and other statutory disclosures of each sample bank and published circulars of State Bank of Pakistan (SBP) relevant to the implementation of Basel III.

The study relied on the disclosures made in quarterly financial statements, non-performing loan positions, on- and off-balance-sheet activity, and capital and liquidity ratios, all of which are relevant to operational risk, made by banks in Pakistan by SBP and Securities and Exchange Commission of Pakistan.

3.4 Analysis Technique

A deductive approach was followed because there was a known regulatory framework (the BCBS's eleven sound principles of operational risk management) to which responses could be mapped. The analysis consisted of five steps: (a) the interview; (b) audio-taping the interview; (c) transcribing the recording; (d) extracting and comparing key points across transcripts; and (e) pooling and summarising responses by participant (P1–P10) and by theme. Secondary data from annual reports were used to triangulate and validate the claims of institutional-level implementation during interviews and to independently validate each sample bank's claimed approach to measuring operational risk.

4. Results

4.1 Branch-Level Awareness of Basel III and Operational Risk

The Basel III initiative has increased awareness of Basel III at the branch level. The participants were asked about their knowledge of Basel and operational risk in the context of Basel II/III. The answers were divided into three main categories as outlined in Table 2: (A) awareness that operational risk is managed by a dedicated internal control/operational risk function or department in head office, but without detailed knowledge of Basel terminology; (B) no awareness that their bank's practices are related to Basel principles at all, and their bank's compliance is viewed as adherence to its own internal rules; and (C) accurate, terminology-specific knowledge of Basel accords and operational risk measurement approaches.

Table 2. Branch-Level Knowledge of Basel Accords / Operational Risk (n = 10)

Participant	A: Aware controls exist, unaware of Basel link	B: Unaware of Basel link; cites internal rules	C: Explicit Basel III knowledge
P1	Y		
P2		Y	
P3	Y		
P4		Y	
P5	Y		
P6			Y
P7		Y	
P8	Y		
P9			Y
P10		Y	
Total	4	4	2

Four out of 10 participants reported that operational risk rules are established and monitored at head office through a specific function (not specifically related to the Basel accords). Another four out of 10 said they didn't know if their bank's practices were based on Basel principles, and that they complied only as per their own policy. Two out of 10 participants explicitly knew the Basel III operational risk guidelines and were able to name the other standardized approach as the bank's measurement method.

4.2 Operational Risk Control Practices Reported at Branch Level

The practices regarding operational risk control were reported at the branch level. Regardless of their Basel III terminology, the 10 participants identified a very similar set of operational risk controls across their branches, including access control, transaction authorisation, customer onboarding, cash custody, information technology, financial crime monitoring, and physical security.

4.2.1 Access Control, Authorisation, and Segregation of Duties

The principles of access control, authorisation and segregation of duties are applied. Each staff member has an individual system ID and password, sharing is not permitted and will lead to immediate termination of employment if found out. Each user ID has a fixed transaction limit and transactions exceeding this limit must be approved by the Operations Manager (OM) or Branch Manager (BM) or signature verified for larger transactions. The bank has three keys for the cash cell — one for the Operations Manager, one for the Branch Manager and one for the teller — indicating the triple-custody control of cash items. SBP also mandates sorting of cash with soiled notes removed from circulation.

4.2.2 Customer Onboarding and Know-Your-Customer (KYC) Controls

To ensure that customers are onboarded and know your customer (KYC) controls are implemented correctly. New accounts are opened after identity verification through Verisys software of the National Database and Registration Authority (NADRA) of Pakistan. The account type corresponds to the customer profile (e.g. a business account for business customers). At account opening, customers agree to terms that allow the bank to reverse transactions that are the result of human error without specific customer authorization, but under internal audit controls.

4.2.3 Monitoring, Audit, and Compliance

To monitor, audit and comply with the requirements of the government and the public. An independent internal compliance/audit department does periodic checks separate from the branch's own activities; the internal audit function is correction-oriented, not penalty-oriented. SBP carries out external audits of its branches at regular intervals, known as “snap” audit, which is an unannounced audit and which can lead to direct financial penalties to the bank for any deficiencies identified during the audit. The internal control and operational risk management committee investigates fraud or deception, and if appropriate, refers it to the competent authority for legal action and recovery.

4.2.4 Information Technology and Data Integrity

Data integrity is achieved through information technology. All branch systems are "live" to servers at the head-office and entries are posted directly and in real time. All transaction entries are automatically saved on three to four different head-office servers so that if one server fails, the data will not be lost. In the event of a posting error, the operations will be suspended until the error is addressed and connectivity issues will be addressed locally where possible and will be brought up the operations reporting line to the Regional Office. Banks reported employing an Operational Risk Management System (ORMS) to monitor and manage operational risk exposures, some of which were in-house developed, while others were based on licensed software.

4.2.5 Financial Crime Monitoring and Shariah Compliance

All sample branches are using anti-money-laundering (AML) software to identify suspicious or unusual transactions. In Islamic bank branches, an extra compliance layer is in place with the existence of a dedicated Shariah board and Shariah compliance department to monitor the adherence of Islamic banking principles, specifically in Islamic bank branches, in addition to the bank's general operational risk controls.

4.2.6 Physical Security and Business Continuity

Business continuity plan (BCP) drills are carried out regularly (annually / bi-annually) to ensure that operations can continue (or be moved) in the event of a disruptive incident. Insurance/Takaful cover, security guards from reputable security companies, and security cameras (some of which are decoy cameras designed to deter potential robbers) are examples of measures that reduce the risk of robbery, and in the event of a robbery, duplicate cameras are located in two separate places to prevent loss of footage. Security guards are taken off of the higher-risk night shifts and night security is instead supervised from head office with live IP camera feeds and alarm systems. In line with the disclosure requirement in Principle 11, all ten sample banks reported on their operational risk measurement approach, which can be either Basic Indicator, Standardized or Alternative Standardized.

4.3 Mapping of Branch and Institutional Practice onto the BCBS's Eleven Principles

In addition to the descriptive practice inventory in Section 4.2, the participants' answers and the annual report review were coded directly to each of the BCBS's eleven sound principles (see Table 3).

Table 3. Reported Practice Against BCBS's Eleven Principles of Operational Risk Management

Principle	Reported practice
1 — Risk culture	Senior management (head office) establish operational risk rules/regulations and then pass them down to branch level.
2 — Framework	8/10 sample banks have developed a Framework which is fully coordinated with existing processes and procedures, including an operational risk administration and assessment framework; 2 banks indicate that they are applying this principle, but did not have a Framework at the time of the study.
3 — Board oversight	Senior management carries out regular snap audits to make sure policies and procedures are adhered to by branch staff.

Principle	Reported practice
4 — Risk appetite and tolerance	The bank's risk appetite and operational risk tolerance level is reviewed by the senior management periodically to fine-tune the policies and procedures.
5 — Senior management structure	Banks have committees like Internal Control Committee and Corporate Operational Risk Function (CORF) to monitor and evaluate the risk of their products, and audit evaluation provides a form of supervisory review.
6 — Risk identification and assessment	Senior management assesses products and services, local branch management requires head-office approval prior to introducing a new product/service.
7 — Change management	New products, services or changes to existing products and services are formally evaluated for risk and must be approved by the Board of Directors.
8 — Monitoring and reporting	Ongoing monitoring and reporting of operational risk exposures is carried out through regular internal and periodic snap compliance audits by SBP.
9 — Control and mitigation	A good control environment is achieved by using unique staff IDs, segregation of duties and tiered transaction authorisation limits.
10 — Business resiliency and continuity	Business continuity drills are held on the sample once a year or twice a year.
11 — Disclosure	All sample banks reported their operational risk measurement approach (BIA, SA or ASA) for their annual reports.

4.4 Institutional-Level Implementation of Basel III Operational Risk Approaches

The pattern of the adoption of Basel III for capital and operational risk purposes, as revealed by cross-referencing the claims made in the interviews with the disclosures in the sample banks' annual reports, was as follows:

- Bank 1: Basel III adopted for Tier II capital and Alternate Standardized Approach (ASA) for operational risk (with permission from SBP) — indicating a readiness to transition to more sophisticated measurement methodology.
- Bank 2: Basel III adopted in accordance with SBP circular requirements, but not yet implemented ASA, still in Basic Indicator Approach (BIA) for operational risk.
- Bank 3: Implemented Basel III as per the latest SBP circular for database and key-risk maintenance, adopted BIA for operational risk.
- Bank 4: Adopted Basel II framework and BIA for operational risk measurement and was ready for transition to Basel III.
- Bank 5: Continues to follow the Basel II approach for measuring operational risk with BIA.
- Bank 6: has started implementing Basel III as per the SBP guidelines and is working towards complete implementation with the help of ASA.
- Bank 7: Currently uses BIA for operational risk but is pursuing adoption of ASA.
- Bank 8: Implements Basel III for Tier I and Tier II capital and Basel II BIA for operational risk management in particular. Basel III framework for operational risk implemented with a

dedicated committee on operational risk, apart from internal control committee, and adopts ASA.

- Bank 9: Applied Basel III framework for operational risk with a dedicated operational risk committee as opposed to the internal control committee and implemented ASA.
- Bank 10: States that Basel III applies to the bank and its subsidiaries, but it also applies this to the Basel II Standardized Approach for credit and market risk capital adequacy and BIA for operational risk.

Overall, 8 out of 10 sample banks have adopted a Basel III approach to capital adequacy calculation and market risk measurement. Of these eight, five continue to use the Basic Indicator Approach to operational risk and three use the more risk-sensitive Alternate Standardized Approach. The other two banks say they are not yet applying Basel III, that they are planning to do so, but are applying Basel II approaches to capital adequacy, credit risk, market risk and operational risk.

4.5 Branch-Level Actions and Practice Summary

Participants were also asked about the actions their branch takes in their day-to-day operations to address operational risk issues (as detailed in Section 4.2). The answers are summarised in table 4 under four themes: (Q1) explicit Basel III knowledge (re-stated for cross-reference); (Q2) compliance with all listed operational rules; (Q3) explicit adoption of the Alternative Standardised Approach (AS) specifically; and (Q4) concrete corrective/preventive actions.

Table 4. Branch-Level Operational Risk Practice Summary (n = 10)

Participant	Q1: Basel III knowledge	Q2: All rules followed	Q3: ASA adopted	Q4: Concrete actions in place
P1	N	Y	Y	Y
P2	N	Y	N	Y
P3	N	Y	N	Y
P4	N	Y	N	Y
P5	N	Y	N	Y
P6	Y	Y	Y	Y
P7	N	Y	N	Y
P8	N	Y	N	Y
P9	Y	Y	Y	Y
P10	N	Y	N	Y
Total	2Y / 8N	10 Y	3Y / 7N	10 Y

The results show that all the 10 participants have the complete set of operational risk rules as described in Section 4.2 (Q2), and all the 10 participants have taken specific preventive/corrective measures at their branch (Q4). Only two participants reported having explicit Basel III knowledge (Q1), and three reported having knowledge of the ASM specifically (Q3) — and — importantly — at the same two participants (P6, P9) who reported Basel III knowledge in Table 2.

4.6 Regulatory Training and Awareness-Building

Perhaps the most common theme among the interviews was the lack of specific training on Basel III. The branch managers said they have not received any formal knowledge sessions on Basel accords, but the training was conducted through their own internally developed curricula which were also aligned with SBP requirements. The actual training of the branch staff is to do what is required to implement the procedures issued by SBP and head office, which are based on the Basel principles, but not clearly stated in the training as being derived from Basel. This is directly in line with the awareness pattern described in Section 4.1 and is elaborated on in Section 5.

5. Discussion

The common denominator in the results is that there is a significant gap between formal regulatory awareness and actual practice. These practices are evident in all eleven of the BCBS's sound principles, and are close to universal in the branches — all ten branches reported following a core set of access control, transaction authorisation, KYC, audit, AML monitoring, data backup and business continuity practices (Section 4.2; Q2 and Q4 in Table 4) — and the branches' governance-driven approach to policy-setting (Principles 1–3), a defined risk appetite process (Principle 4), a clear senior-management structure (Principle 5), risk identification and change management in products and transactions (Principles 6–7), monitoring and escalation (Principle 8), a documented control environment (Principle 9), business continuity planning (Principle 10) and disclosure (Principle 11). But only two of 10 branch managers could correctly identify these practices as being specifically related to Basel III, and only three of 10 banks have implemented the more risk-sensitive Alternative Standardized Approach for operational risk capital, despite Basel III's adoption for capital adequacy and market risk. This is a pattern that indicates that operational risk compliance at a branch level in this sample is largely achieved by the standard operating procedures that are issued from head office, rather than by the understanding of the Basel III principles that the standard operating procedures are supposed to meet by the branch staff. From the BCBS' perspective, this aligns with the function of the first line (the business line) of defence, which is expected to implement controls in a competent way, but does not have the formal responsibility for the risk-framework literacy that is expected of the second line (an independent corporate operational risk function) and the board (Principles 1, 3 and 4). This is similar to what Sabato (2010) described as the absence of understanding, or communication, within the strategic risk framework that the operational controls were intended to support, a situation that was observed at the branch level in this study within an emerging market, post-crisis regulatory environment. The overlapping of the Basel III knowledge and of ASA adoption between the two participants (P6, P9) also indicates that at the institutional level, knowledge and familiarity of Basel III and the adoption of ASA are related: banks that invest more in ASA-level analytical capability tend to be more Basel III literate at the branch level, but banks that are still on BIA do not necessarily invest more in Basel III compliance at the branch level, given that they tend to manage operational risk through simpler, rule-based compliance. This is in line with

Munro's (2010) results that board-level risk management enhancements since the financial crisis were not uniformly adopted, but varied by institution. Another significant difference is that while 8 of 10 banks have adopted Basel III for capital adequacy/market risk, 5 of the 8 adopting banks are still using the Basic Indicator Approach for operational risk specifically. The BIA's continued prominence, despite the shift to Basel III by banks that haven't yet adopted the new regulations, suggests that the operational risk aspect of Basel III implementation is lagging behind the capital/market risk aspects in this sample. This is in line with observations made by the BCBS that operational risk capital requirements have been relatively unchanged compared to the growth in operational risk exposure since the 2007–2008 crisis (BCBS, 2014), and Jongh and Van Vuuren's (2013) claim that despite its proven impact on crisis severity, operational risk has historically been treated with less measurement focus than credit or market risk.

Finally, the granular practice evidence in Section 4.2 demonstrates that Basel consistent operational risk management in this sample is not contained in general policy statements, but rather in very specific and locally adapted practices, notably the triple-key cash-custody control, the use of NADRA-based KYC verification and the distinction between internal/external audit, reported by participants. This helps correct the Basel-implementation literature, which focuses on the extent to which the institution has implemented Basel and declares its capital ratios (e.g., Rime, 2001; Al-Tamimi, 2008); a bank may have a good score on the paper side on Basel III implementation but on the operational side, branch staff may be executing a set of local Basel-like controls with little awareness of how those controls relate to Basel.

6. Theoretical Implications

The results expand the existing operational risk literature by reporting at the branch level a distinction between a procedural compliance (a focus on following prescribed controls) and a regulatory literacy (an understanding of the framework those controls are intended to meet). Much of the current Basel literature treats implementation as an event which occurs at the bank-wide level, and focuses on institutional disclosure and capital ratios. The evidence in this study indicates that implementing Basel III operational risk requirements could be a multi-layered process, with the formal implementation of the framework taking place at the institutional/disclosure level and the adoption of the framework at the branch/operational risk level lagging behind — even though the operational risk controls themselves are already largely in place. It is relevant to the conceptualization of operational risk culture (Principle 1) and risk governance frameworks (Principles 2–5) as being diffused from the board and senior management down through the first line of defence and the idea that regulatory literacy and operational compliance are not necessarily co-occurring aspects of “implementation” in future conceptualizations of Basel implementation in emerging-market banking systems.

7. Practical Implications

The results suggest the following practical implications for banks and supervisors, in line with the recommendations in the study itself:

Targeted training: Banks should consider conducting structured training on Basel operational risk principles for operations in the branches and branch managers instead of just issuing SOPs internally that are consistent with Basel principles. Labeling existing procedures as Basel-derived and including this labeling in the routine training will bridge a lot of the awareness gap at low cost.

Building capability toward ASA: Banks that are already implementing the Basic Indicator Approach should be provided support in developing business-line-level risk measurement capability needed to move to the ASA, which provides more risk-sensitive capital allocation for operational risk.

Regulatory support for transition banks: SBP should provide targeted assistance to the banks that have announced that they will apply Basel III, but have not done so yet, to bridge the gap between the announced intent and the actual operational implementation.

Adequate staffing: Banks should not have overly “lean” staffing models in branches as it would undermine the segregation of duties and dual/triple-custody controls (including cash-cell access) that several of the reported practices rely on (as per sound operational risk control (Principle 9)).

8. Limitations

The results of this study must be interpreted with a number of limitations in mind. First, the sample is a relatively small number of ten bank branches, in just one city (Peshawar), restricting the generalisability of the findings to the banking sector in Pakistan as a whole or other cities. Second, the qualitative interview data are self-reported managerial narratives of operational risk practice that could be socially desirable in nature, especially for compliance behaviour. Third, the analysis of the interview transcripts was done by a manual point extraction and tallying method without a formally documented qualitative coding protocol (e.g., software-assisted thematic coding with inter-rater reliability checks), so that the methodological transparency of the qualitative results is limited. Fourth, the data are based on one point in time in 2016-2018, when the Basel III transposition in Pakistan was still active and the pattern of implementation might not accurately reflect the current situation of the transposition.

9. Future Research

Future research may expand this level of analysis to a larger, multi-city sample to determine whether the awareness–practice decoupling found in this sample is replicated in the broader banking sector in Pakistan as well as whether the relationship between Basel III regulatory literacy and more sophisticated measurement practices (e.g., ASA) found at the institutional level in this sample is generalizable.

10. Conclusion

The study analyzed Basel III operational risk knowledge, operational risk control practice and Basel III implementation in institutional framework of ten commercial bank branches in Peshawar, Pakistan through triangulated evidences of interviews and annual reports. It concludes that the Basel III framework is not explicitly referenced by a majority of branch managers, and that the more risk-sensitive Alternative Standardized Approach for operational risk is not adopted by most banks even those that have adopted Basel III in other areas. Training data confirm this: Branch staff are trained on procedures that they are issued by their employers, and that are aligned with the SBP, and not on the Basel framework that these procedures instantiate. The results of this study highlight a practical and theoretical gap between operational risk compliance and operational risk literacy and have implications for the design of training and support for the ongoing implementation of Basel III at the branch level in Pakistan.

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