ENCLOSURE 2

Specific comments related to Operational Risk

Definition of operational risk (section 6)

In section 6 of CP2, operational risk is defined as "the risk of direct and indirect losses resulting from inadequate or failed internal processes, people and systems or from external events".
In section 7, the Basel Committee adds that the capital charge should cover direct as well as certain indirect losses.

Response
We recommend that operational risk be defined for regulatory capital purposes in general terms as ***"****the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events that is not already covered by other regulatory capital charges (i.e. credit, market, and banking book interest rate risks). Business, strategic and reputation risks are expressly excluded****".*** Work has been done by member banks participating in the IIF in order to develop a number of definitions to determine the specific losses that should be covered by the operational risk regulatory capital charge. These definitions may include some losses that are currently covered under the credit risk regulatory capital requirements. This potential overlap in definitions requires further clarification from the Basel Committee as to the appropriate definition of risk types in the New Basel Capital Accord.

Definition of operational risk losses

In section 8, the Committee states that it is cognisant of the difficulties in determining the scope of the charge and is seeking comments on how to better specify loss types for inclusion in a more refined definition of operational risk.

Response:
In order to be able to build relevant models on operational risks, banks must have sufficient data that are measured and compiled in a uniform manner. It is therefore important that the Committee determine the definition of operational risk and its measurement. The banks need to invest significant effort in collecting data for databases. There should be clarity on what to register: operational risk events-types based (eg. execution failure, illicit conduct) or financial effect-type based (eg write-down recourse).
We would like to recommend to adhere to the definitions of operational risk losses that are currently being supported by as large a group of industry participants as possible. These definitions, offered in direct response to the Consultative Proposal's request for comment on how to further specify the coverage of operational risk regulatory capital, are as follows:

1. An operational risk loss is the amount charged net of recoveries to the profit and loss account in the resolution of the operational risk event.

2. Amount charged net of recoveries is determined in accordance with Generally Accepted Accounting Principles (GAAP). Recognition of an operational risk loss as a data point for regulatory capital purposes is triggered by the recording of a charge to the profit and loss accounts. The date attributed to the loss is the date on which the profit and loss account charge is first recorded. If the loss amount changes in future periods (eg., when a recovery is made), adjustments are recorded as changes to the original loss data point and do not result in a new data point.

3a. *External Costs* are the gross compensation costs and/or penalty payments to third parties.

3b. *Write-downs* are the loss in value of any asset owned

3c. *Costs to fix* include only external payments directly linked to an event and exclude internal costs

We are against the incorporation of near losses, latent losses or contingent losses as this is theoretically incorrect and will in practice not be workable and controllable (level playing field). In the calculation of credit risk, near defaults are excluded also.
Note that the tracking of such occurrences may be of value in so far as lessons may be learnt that can contribute to the better management of an organisation. This is not to say however, that the tracking of near losses, latent losses or contingent losses should be incorporated in the capital charge.
We pull attention to the treatment of other risks which seems to be open-ended. In order to reduce the scope of ubiquity we appreciate further clarification.

Expected versus Unexpected losses (section 9-14)
In section 9 it is stated: In line with other banking risks, conceptually a capital charge for operational risk should cover expected losses..

Response:
As a matter of principle, the regulatory capital charge should only cover unexpected losses. If expected losses are covered, loss deductions, provisions, and the loss absorbing capacity of current period earnings should be recognized in the calibration of the regulatory capital requirement. Likewise, correlations between operational risk losses should be recognised. Insurance activities should not be included within the scope of the regulatory capital charge as they are currently subject to a separate regulatory and solvency regime. However, the Basel Committee should seek to foster international harmonisation of banking and insurance regimes, particularly when insurance activities are integrated with banking activities.

Interaction with pillars 2 and 3 (section 15-16)
In section 15 it is stated that: All three pillars of the New Basel Capital Accord – minimum capital requirements, the supervisory review process and market discipline – play an important role in the operational risk capital framework.

Response:
The supervisory actions under Pillar 2 should be executed in a consistent and transparent fashion. All methods used to determine the capital requirement should be specified under Pillar 1. We look forward to the publication of a paper on sound risk management practices by the Basel Committee in order to provide specific input in this area.
We believe that enhanced public disclosure is beneficial, as long as the disclosures provide timely, relevant and appropriate information about risk levels and risk management practices. However, we do not believe that the disclosure of actual raw operational data meets these criteria.

Capital charge (section 21)
In section 21, it is explained why operational risk will be approximately 20 % of current regulatory capital. Besides, it has been said that the total amount of capital should not decrease on average in the industry (section 46 in the document 'Overview of the New Basel Capital Accord")

Response:
The Committee aims at an operational risk charge that will on average be 20 % of total capital charges in the industry. However, it is yet unclear what happens if some industry participants move to a more sophisticated measurement approach of operational risk. Will the "beta" factors in the standardised business line be increased when many institutions move or will the total capital for operational risk decrease ?

Basic Indicator approach (section 22-23)
In section 23 the Committee states that alpha will be set at around 30 % of gross income. This percentage is calibrated on a limited amount of data. In addition, the section argues that this percentage might even be higher in order to move towards more sophisticated approaches.

Response:
It is unclear how "alpha" is determined. Why is it set at 30 %. The Committee states that this may be increased with an add-on as well.
We would appreciate further information on the setting and modification of this factor, the more so since it may be crucial for incentives to move towards option 2 or 3.

Standardised approach (section 24-30)
In section 26 the proposed indicator per business line is presented. For corporate finance, trading and sales and retail brokerage, gross income is proposed; retail banking and commercial banking get annual average assets as financial indicator; payment and settlement get a capital charge related to the annual average settlement throughput and asset management is charged for the assets under management. Besides,

- *in footnote 11 it is stated that Private Banking has been allocated to the retail banking business line;*

- *in footnote 12 on page 19 it is stated that the payments and settlement losses related to a bank's own activities should be incorporated in the loss experience of the specific business line.*

Response:
In the standard approach, all indicators are related to balance sheet and P&L except for the business line payments and settlements. The indicator mentioned for this business line will be more difficult to audit. It is not clear what is meant by footnote 12 on page 19 on payments and settlements.

A second observation is that all indicators are size or money driven. Their relation to the degree of operational risk still needs to be determined. Furthermore, any such relation is very likely not linear in nature. The non-linearity of such indicators is a critical factor to be taken into consideration. Square root functions or other forms of digressive functions are conceptually better. It is therefore required that the CP II regulations allow for adjustments to the various factors as and when sufficient data are available to quantify the relationship between the indicators and the extent of operational risk incurred. For example one transaction of USD 500 million may have a different risk profile from 5 transactions of USD 100 million.
Corrections could be made, based on the risk profile of the institution and on the quality of the internal control environment.

The operational risks of private banking and retail Business are significantly different. We recommend that Private Banking be included in the Asset Management business line.

Internal Measurement Approach (section 31-39)
The internal measurement approach is based on internal data and in the second bullet of section 39, the Committee requests the industry to accelerate industry efforts to pool loss data. All elements in the internal measurement approach will be based on these data.

Response:
There is insufficient scope for the inclusion in the measurement of qualitative elements (risk assessment and audit results) in the proposed internal measurement approach. In this stage it is not desirable to restrict the development process of operational risk measurement and tools in such a way. The heavy focus on collecting data of operational risk losses narrows the scope of the development process and reduces its predictive value.

For market risks, already there has been much discussion about the reliability of the models being used. Another issue is whether history is a good basis for predicting the future. For operational risk, these problems will be even bigger. Given the present unavailability of data it will take years for statistically reliable data to become available. Furthermore, banks should learn from their mistakes. A qualitative judgement on the controls and risk management process is in our view of higher value than just looking at operational loss history. There is a danger that because a bank has not suffered from losses, despite its poor controls and poor data collection it is in fact rewarded with a low charge compared to a bank with better

controls and good measurement of internal losses, which for some reason suffered from an (incidental) loss.
The question is whether a big operational risk event should stimulate an improvement in risk management and controls, or simply result in an increased solvency requirement.

In the standardised approach, operational risk capital is measured with the use of risk indicators per business line. The Committee recognises that the relationship between risk indicators and loss data is not proven yet. It is doubtful to base regulation on an assumed but unproven relation between certain risk indicators and yet to be determined loss data. For the standardised approach this may be acceptable, but for the internal measurement approach there should be more freedom to develop measurement methods based on other and possibly better assumptions. The currently proposed methods do not enable sufficient incorporation of the impact of fast emerging techniques and product and market changes. The question is how to allow measurement techniques the flexibility to adapt to ever faster changes in technology, measurement, management and market developments. What is state of the art now, may be obsolete in three years' time.

Criteria on history

The number of years of data history still needs to be determined. Given the implementation date of the year 2004 and given that furthermore, the question about commonality of definition, approach and datasharing among the industry participants is still outstanding, banks have in effect little time left to build their required data bases on a uniform basis. It may therefore not be feasible for banks to develop models by the year 2004, which will be based on data that cover a three year period. In that case, we recommend that banks be allowed to initially use their models based on data covering a two year period, provided of course that criteria of statistical soundness are met. As time progresses, models can be updated and the time series on which they are based expanded.

Industry gamma and major losses

It is proposed to use an industry gamma that will be applied to a bank's specific expected loss. If one institution faces a major loss, which is captured in its internal loss database, this one loss might have a major impact on the capital charge for operational risk. If an industry gamma is introduced, major losses should be kept out of the internal loss database. It is not clear to us how the Risk Profile Index works in this respect.

Loss Distribution approach (section 40)

Response:

For the Loss Distribution Approach (LDA), it is important that both internal and also external data are used for determining frequency (eg. Poisson) and severity (eg invers Gaussian) models in combination with exposure indicators and inherent risk factors to calculate capital. LDA can also include self-assessment scoring models to adjust for quality of controls.

Moreover we suggest that the banks further evaluate in what manner the current methods being used by insurance companies and bankassurance companies, can be of use for the purpose of determining a relevant loss distribution approach for operational risk within banks. Perhaps, the Committee should allow itself and the industry some leeway to adjust its capital charging regime to such LDA-type approaches.

Qualifying criteria (section 41)

Response:
The qualifying criteria for the standardised approach may be demanding. We doubt whether this is in line with the simplicity of the standardised approach. To be able to qualify for the standardised approach, the Committee requires banks to start with the registration and reporting of operational risk loss events. If the standardised approach is the intended end station of an institution, there is no direct need for those internal data. In our view no requirements upon the gathering of data can be made in this stage. In the qualifying criteria upon measurement, no attention is paid to the qualitative measurement methods. The assessment of the quality of internal controls can also be regarded as a measurement tool.
Besides, the criteria as well as the business line approach in itself, implicitly show a tendency towards more centralised organisational structures. This implicitly supposes that decentralised risk management structures are less effective. We question whether this is the case.

To prevent the level playing field from being disturbed, the Committee should pay much attention to clarity and definitions.

The floor concept (section 45-47)

Response:
More clarity is required on the way a floor is set (individual banks/industry/rigid/sliding scale). There is also a significant risk that using internal data might lead to a higher capital requirement compared to the standard approach. If this is the case, institutions may not develop internal measurement approaches. The Capital Accord will then turn out to be counter-productive.

Risk transfer products (section 49-50)

Response:
The Committee did not give a clear statement on the recognition of operational risk transfer products. Risk transfer or insurance might indeed lead to a counterparty risk. This justifies that risk mitigation techniques will not lead to a 100 % reduction of operational risk capital. Whilst such mitigation may be desirable, it should however not result in the bank becoming less sensitive to operational risk.

Pillar 3: Market discipline

The Committee distinguishes core disclosure requirements and supplementary disclosures. The core disclosures are “requirements” and the supplementary disclosure items are “strong recommendations”.

- The core disclosure relates to the stage and set up of the operational risk management in the bank (policies, structures, risk reporting system, documentation, independent review)

- Supplementary disclosure of actual operational losses should be handled with care and taking into account that there is a risk that their disclosure may be misunderstood, thereby creating unjustified damage to the bank (and even cause operational loss!). Before such disclosure is considered, the Bank will carefully reconsider the benefits of disclosure against the potential damage it may cause and/or ‘prepare’ recipients of such a disclosure.