To: **Basel Committee on Banking Supervision**
Bank for International Settlements

From: **OpRisk Ltd. and The FICON Group, LLC**
San Bruno, CA U.S.A.

Comments on New Basel Capital Accord

May 29, 2001

We are pleased to comment on the proposed revisions to the Basel Capital Accord. Our firm, OpRisk Limited and its parent company The FICON Group, LLC focus on operational risk in the products and consulting services we provide to the banking and financial services communities, therefore, the majority of our comments will be directed to the subject of Operational Risk and focus mainly on banks located in the United States of America. We will, however, briefly comment on the operational risk factors that affect Credit and Interest Rate (Market) risks too. Our comments are based in part on the combined 105 years of banking and consulting experience within our four person staff.

WE CONCUR WITH THE COMMITTEE THAT THE NEED TO INCLUDE AND EMPHASIZE OPERATIONAL RISK IN THE NEW CAPITAL ACCORD IS EVIDENT:

Recognized and reputable studies reveal a global problem that results in several billion U.S. Dollar equivalent losses per year for banks from operational risk (internal and external fraud, human mistakes and systems failures). While these losses alone are adequate justification for increased scrutiny by bankers and regulators, the fact that many losses may not be reported, for fear of embarrassment and other reasons only compounds the justification for more focused attention. Also troubling is the fact that additional losses occur that are often improperly categorized (eg. loan write-offs charged as loan losses that result from other undesirable activities such as collateral mismanagement, a clear operational risk loss). The problem of operational losses is growing larger every year.

We believe that a significant portion of the operational risk that a bank incurs is a matter of quality of controls, policies, procedures and monitoring practices, not just the quantity of its lending, investment and other banking activities. Unlike credit risk and interest rate risks that lend themselves to quantification because they are measurable with absolute values, are predictable with reasonable certainty if the sample size is sufficiently large and the quality of data gathering is more reliable, operational risk is significantly different and is not today readily quantifiable (and therefore not appropriate for determining capital levels) for the additional following reasons:

1. The losses sustained tend to be random, not predictable and this is particularly true with the more sizeable losses.
2. The losses are not uniformly measurable and predictable (eg. a fraud loss at Bank A and one of similar nature at Bank B are unrelated events and the size of loss at one is only related to the other by the laws of chance…hardly a sound basis for measurement). All other things being equal, there is sound basis for arguing that the frequency of loss at each bank is not predicable based solely on mathematical calculations.
3. The probability of loss among organizations is more a function of the quality and application of individual control systems in place at each bank rather than a mathematical probability of historical averages projected forward.
4. Existing industry loss data (minimal as they are) have not been gathered on a consistent basis and are suspect due to clear reluctance to share such information between institutions for reasons of confidentiality and embarrassment. Because

of this, any attempt to assess the predicted exposure of an individual bank by comparing circumstances and conditions of losses and potential losses in the database is not dependable.

This is not to say that quantification is an undesirable goal. We believe it is desirable and necessary but we disagree that it is the best way to approach and determine proper capital levels as the banking industry and its regulators begin to address the issue of operational risk. Rather, we think quantification should be a resulting process that derives from more productive initial activities, those initiatives geared toward ensuring improved quality of controls, systems, procedures and policies and the proper adherence to them. **If proper and desirable control factors exist at a bank and are properly followed in daily operations, it is likely to be a bank with low operational risk and losses, particularly in comparison with other banks with lesser-controlled environments. We believe this is true for any bank regardless of size. In the case of large and complex banks, quantification is perhaps more important in the interest of safety and soundness of a national banking system and the threat to deposit insurance programs. In the case of small banks, that represent only limited exposure for system safety and soundness and deposit insurance funds, <u>qualitative responses to the operational risk mandate are probably sufficient in determining capital charges.</u> <u>Approached as a quality issue, operational risk is significantly diminished at the outset and as time passes, the opportunity to gather and report meaningful and consistent data is enchanced. This suggests that supervisory discretion, experience and judgement will continue to be all important.</u>**

Some observers have postulated that small banks should be exempt from the New Basel Accord, particularly as it pertains to operational risk. We respectfully disagree and disagree strongly. While smaller institutions do not represent the degree of risk to either national or global banking systems or deposit insurance funds that larger banks do, the memory of the U.S. Savings and Loan debacle, the earlier U.S. Agriculture Bank problem and the painful memory of the economic, political, publicity and legislative fallout that accompanied these situations is still too fresh to allow smaller institutions to be overlooked. Further, smaller institutions tend to be located in smaller communities, many of which are single bank towns and the effect of losing a local bank for any reason is devastating to that community, even if a takeover and assumption transaction occurs. Of equal importance, smaller institutions should not be denied the **opportunities** available under the New Basel Accord to improve their returns through achievements in improved operations and monitoring. **<u>Affordable and workable operational risk management systems and programs are available in the market and can be utilized by any bank no matter how small. The remedy is readily available, affordable and manageable. Smaller institutions should not be ignored nor denied the opportunity to prove lower risk profiles and hence opportunity for higher returns on in invested capital.</u>**

In summary, we believe the proposals to emphasize operational risk are soundly based and needed. The specific program proposals are sound and the implied importance of emphasizing the qualitative aspects of operational risk management is good. However,

any plan to quantify and perhaps assign a ranking number to each institution for operational risk is premature and secondary in importance at the outset. Quality of controls and systems within each bank for assessing and managing operational risk should receive the primary emphasis. As the industry and regulators gain experience with systems that monitor and assess operational risk, the opportunity to gather high quality and consistent data will make quantification efforts more accurate and usable. During the initial years while more accurate data gathering is occurring, the benefits of focusing on the qualitative aspects of operational risk will pay great rewards to banks and the supervisors that oversee them. No doubt, potential bank failures will be avoided. Regulations should provide the opportunity for smaller banks to manage their capital positions to achieve higher returns through better management of their operational risk exposures. Respectfully submitted.

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John E. Brubaker
Chairman and CEO
OpRisk Ltd. and The FICON Group, LLC
1250 Bayhill Drive, Suite 200
San Bruno, CA 94066
(650) 348-1612
jebrubaker@oprisk.com