The voice of banking & financial services

25 February 2011

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Dear Sirs,

Sound practices for the management and supervision of operational risk

The British Bankers' Association ("BBA") is the leading association for UK banking and financial services for the UK banking and financial services sector, speaking for over 230 banking members from 60 countries on the full range of the UK and international banking issues. I am pleased to say that all the major banking players in the UK are members of our association as are the large international EU banks, the US banks operating in the UK and financial entities from around the world. The integrated nature of banking means that our members are engaged in activities ranging widely across the financial spectrum encompassing services and products as diverse as primary and secondary securities trading, insurance, investment banking and wealth management, as well as deposit taking and other conventional forms of banking.

The BBA is pleased to respond to the consultation on sound practices for the management and supervision of operational risk.

Key comments

Clarification of what supervisors expect from a statement of operational risk appetite and tolerance would be appreciated. Operational risk is different from credit and markets risks, where such statements are requisite.

We do not believe that it is realistic for the board to have sufficient time to get involved with operational risk management, for example the setting and policing of limits. This is more appropriate for senior management. It is the extent of the board's active involvement across the operational risk framework as envisaged in the paper which is the concern, rather than the principle behind it. The paper doesn't make enough allowance for the board using its discretion to determine which matters are material to it and which issues should be delegated to senior management.

We note a supervisory preference for the Loss Distribution Approach (LDA) rather than the inclusion of scenarios into modelling. We believe that both elements have their part to play.

We do not believe that business process mapping is necessary for all activities. Such mapping should be reserved for higher risk activities and should be an optional activity.

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There is no mention of boundary losses in the paper. It would be helpful if the approach across the industry and any supervisory expectations in relation to the treatment of boundary losses could be clarified.

There are still challenges in implementing a risk appetite framework for operational risk and it not as simple a copying processes which work for credit and market risk. Further guidance on appetite would helpful. At a minimum, details on what should be in an appetite statement and how it should be used would facilitate consistent implementation of the appetite statement across the industry.

The operational risk management approaches of our members are built around key risk identification and include risk transfer through insurance (paragraph 104) where appropriate. Insurance transactions are to a significant extent based on trust between the parties and, over the years, our members have developed strong relationships with the insurance market. Many of our members own insurers and insurance brokerages (the latter operating in the Lloyds insurance market). We believe that there is a need for an appraisal of the insurance products newly available to banking institutions. In addition, regulators should provide more encouragement to the insurance industry to co-operate more closely with the banking sector in order to create innovative solutions in operational risk management and offer policies that are better suited to the existing needs of these clients.

The bank's college of supervisors should agree a common approach so that the firm has an idea of regulatory expectations across its span of businesses.

Conclusion

The guidance should be applied in a proportionate manner.

The Annex to our letter contains our formal response to the guidelines proposed in the consultation, and further specific observations and questions arising from the proposals.

We hope that you will find our comments useful. Please contact me by way of email (irving.henry@bba.org.uk) or telephone on (0) 20 7216 8862 should you require further information.

Yours faithfully,

Irving Henry
Director, Prudential Capital and Risk

Annex

Operational risk appetite

We acknowledge the importance of moving towards a methodology for operational risk appetite. However, regulatory engagement with the industry is essential in development of such a methodology, before it becomes mandatory.

In practice firms do not seek to "extend" operational risk, as opposed to market or credit risk where firms will explicitly take on market or credit risk, balancing this versus anticipated returns. Operational risk is different and most firms consider risk tolerance for operational risk losses, as opposed to operational risk appetite.

Whilst "'tolerance" can be defined for some discreet types of operational risk (such as internal fraud, regulatory sanctions - where the tolerance is either zero - or credit card fraud - where tolerance can be expressed in basis point terms, akin to credit risk), the aggregation to a single appetite statement across all types of operational risk will be problematic. An operational risk tolerance framework with a series of principles defined for individual risk types may be more practical and valuable to the Board.

Operational risk appetite / tolerance must also be differentiated from market risk and credit risk:

Operational risk losses can be practically unbounded; operational losses are not simply related to the size of the firm and cannot normally be capped (e.g. by exposure limits or stop loss scenarios).

Operational risks are not easily controllable in the short term; there is no ability to trade down/close positions and there is often a significant time lag between cause and effect.

As a result much clearer understanding is required on how practical operational risk "limits" could in practice be established.

Principle 1

All sorts of risks are being put on operational risk management’s watch. We believe that too much responsibility is being placed on operational risk (management). A wider piece on risk management and the need to engage a greater variety of stakeholders should be considered. The proposals on board involvement and governance would, perhaps, be more appropriately addressed in a paper on sound practices for credit risk management.

There is a danger in placing too much responsibility on the board, which is unrealistic given the breadth of their overall responsibilities. A clearer idea of regulatory expectations of board supervision and delegation to a management committee would be helpful.

Principles 1 and 3 - 4

Reference to the role of the board are applicable not just from an operational risk perspective, but from a broader risk management perspective. Some of the responsibilities being asked of the board are very prescriptive and do not take into consideration the fact that governance structures in banks operate on the basis of an established delegated authorities structure. The role of the board is therefore focused more on setting risk appetite and ensuring material risk exposures are being managed within the same. Day-to-day risk management and oversight responsibilities are delegated to other senior management level risk committees.

Consistent with this:

- The proposal under Principle 5 to have non-executive directors on management level operational risk committees should be reviewed. Banks should be able to justify their governance structure based on the principle of proportionality.

- Reporting of information to the board should focus on material issues and exposures.

Principle 2

Paragraph 25: Clarification is required on how results of the bank's operational risk assessment should be incorporated into the overall bank business strategy development processes. Is this referring to development of an Operational Risk Appetite statement or rather to the stronger linkage between operational risk and new business processes?

Paragraph 26 / 28 (b): We question whether the Board itself, should be approving the operational risk policies or any changes to those policies. Or whether it should be sufficient for a senior committee to which the board has delegated operational risk responsibilities to review and approve changes to operational risk policies.

Paragraph 26 (e) - implies an overall MIS system should be in place for operational risk. If the data used for reporting is in multiple forms, e.g. excel spreadsheets, access databases etc, would this still be considered acceptable as best practice?

Principle 3

Paragraph 28: Given that this paragraph states that the operational risk framework should be regularly reviewed and in quite an amount of detail, it is impractical that this done by the board of directors. We propose that it is sufficient for a senior management committee to which the board has delegated operational risk responsibilities to perform most of the tasks as outlined in paragraph 28.

Principle 4: Further industry discussion should take place before this principle becomes a requirement. Currently, appetite statements in use by member banks are statements of the banks' principles on the management of operational risk. At the present time, the use test is a far more sensitive tool for demonstrating that management bases decisions on operational risk management Information. Therefore, evidence of use and embedding of the risk framework should serve as a proxy for detailed operational risk appetite statements until such time as an industry consensus on such statements can be achieved.

Paragraph 30: Further guidance on appetite would helpful. At a minimum, details on what should be in an appetite statement and how it should be used would facilitate consistent implementation of the appetite statement across the industry.

Principle 5

Paragraph 37 (b): If the board delegates to specific senior management the responsibilities of operational risk, it is questionable whether independent non-executive board members should be required to sit on the management level operational risk committees as defined in 37(a).

Principle 6

Paragraph 39 (d): Although it is clear that business process mapping can assist in identifying and assessing operational risk, it is noted that mapping all processes within an organisation would require significant cost and resources, often for limited benefit. We would suggest thatm rather than being considered a standard best practice operational risk tool, business process mapping be noted as an optional operational risk assessment tool which could be used in high risk or problematic areas at the bank's discretion.

Paragraph 40: Further guidance on the inclusion of the risk of operational risk loss in terms of product pricing is required. If this is to be achieved via a cost of capital allocation then it would be driving capital down to a granularity which is very difficult to determine - particularly when considering individual products. The link between (operational) risk management and pricing is contentious and more complex to align in wholesale markets than with retail products.

As with principle 1, there is a need for an overarching risk(s) piece and wider engagement on risk management.

Whilst reference to internal pricing and performance measurement is noted, more visibility is required around existing practices to allow firms to consider how these requirements can be met. This is an area where more work is required from an industry perspective.

Principle 7

This seems to suggest that operational risks related to new products can be fully assessed. Whilst the intent is noted, the challenges associated with being able to fully assess should be recognised. Data availability is / can be a key constraint.

Principle 8

Paragraph 44: The first sentence should be clarified, especially the reference to stressed conditions.

Paragraph 45: There is an assumption that a firm has a statement of operational risk appetite. We would welcome guidance on this statement.

Principle 9

Paragraph 53: This is a general paragraph on technology infrastructure. However, mergers and acquisitions activity is noted specifically as possibly resulting in a “fragmented and disconnected infrastructure, cost-cutting measures or inadequate investment”. Why are mergers and acquisitions highlighted? Cost-cutting and inadequate investment can be prevalent at other times – periods of recession for example.

Paragraph 54: The scope of the point, as worded by "an affiliate of the corporate group or an unaffiliated external entity" is not particularly clear. Broadly this is understood to mean within the corporate group of companies (internal) and outside it (external). Can the Committee, please, confirm that this should be the interpretation?

Paragraph 54 (f): We assume that viable contingency plans refer to business continuity plans. Can the Committee, please, clarify if this has a wider scope?

Paragraph 55: The paragraph states that "in circumstances where internal controls do not adequately address risks...management can seek to transfer the risk to another party, such as through insurance". This paragraph may be improperly interpreted to see insurance as a substitute rather than a complementary process. Paragraph 56 clarified this - however similar wording in Paragraph 55 would be preferred.

Principle 11

Clarity on what constitutes good practice would be most welcome. It’s not clear that transparency necessarily leads to stability.

Paragraph 61

Clarity on how disclosures on operational risk management are to be assessed would be helpful.