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February 25, 2011

IIF Views on the Basel Committee Consultative Documents on Operational Risk

The IIF's Working Group on Operational Risk is grateful for the opportunity to comment on the two consultative documents issued by the Basel Committee on Banking Supervision (BCBS) in December 2010 – *Sound Practices for the Management and Supervision of Operational Risk* and *Operational Risk – Supervisory Guidelines for the Advanced Measurement Approaches.*

The renewed attention to operational risk is timely given that the industry is now preparing for the implementation of the recently finalized Basel III rules. These new rules require considerable investment in IT, systems, and human resources, which must be put in place in a relatively short amount of time, as do many other regulatory changes coming on stream at the same time. The simultaneous implementation of many complex changes could potentially be a source of significant operational risks for the industry, in addition to having to operate in a very challenging business environment.

The Institute has a number of comments on the two documents, which are discussed in turn below, and welcomes the opportunity to share these with the BCBS.

Comments on Sound Practices for the Management and Supervision of Operational Risk

The Institute commends the BCBS for updating its 2003 paper on the same topic. This updated version benefited from the substantial knowledge the BCBS gained from its various initiatives, particularly the loss data collection exercise, the quantitative impact studies and the range of practice reviews. However, it should be considered that this document applies not only to banks under the advanced measurement approaches (AMA), but equally to banks under the basic indicator approach (BIA) and the standardized approach (TSA). Some of the "sound" practices recommended in the paper may seem like aspirational "best" practices for BIA and TSA banks. For example, the requirement that banks identify, consider and incorporate operational costs and risks of operational loss in internal pricing, performance measurement, and new product approval process may be unnecessarily onerous, and even unrealistic, for non-AMA banks.

Some of the expectations may also not be practical, particularly those relating to the role and responsibilities of the Board. A clearer distinction as to the responsibilities of the Board and senior management should be made. While the Institute agrees that the Board has a critical role in promoting a strong risk culture by setting the "tone at the top" and establishing robust risk policies,

we do not consider reviewing and monitoring "limits", which is best left to management, as part of this role.

The three lines of defense framework advocated in the paper also needs some clarification. The second and third lines of defense seem to have overlapping functions, especially with respect to verification and validation. Verification and validation form part of the second line of defense, i.e. the corporate operational risk function, since it also involves challenging inputs to and outputs from the bank's risk management, measurement, and reporting systems. A clear delineation of the roles that the second and third lines of defense play in the area of verification and validation should therefore be made.

Finally, the statement in paragraph 16 that "review and validation may be done by audit or by staff independent of the process or system under review, but may also involve other suitably qualified parties from external sources," should be applicable not only to smaller banks but also to large ones. The statement reflects the common practice employed by banks in implementing their review and validation functions.

The Institute's detailed comments on the sound practices principles are discussed below.

Fundamental principles of operational risk management (Principles 1 and 2)

The fundamental principles presented in the paper relate to the leadership role of the Board in promoting a strong risk management culture, and to the operational risk framework being fully integrated into the bank's overall risk management processes.

Principle 1

The BCBS recognizes the different types of Board and senior management structures found globally in a footnote to Principle 1 (*footnote 7*). The Institute believes this flexibility when it comes to management structure is extremely important and would like to see it emphasized more strongly in the main body of the text.

The Institute agrees that the Board has a role in establishing a healthy risk culture and setting a good tone for the rest of the firm to follow. However, much of this Principle and subsequent paragraphs would be better placed in a broad risk management context. To bring issues such as compensation strategies into the remit of operational risk supervision will expand the scope of operational risk beyond a reasonable definition, and one that would confuse responsibilities in many firms. The Institute has published extensively on the need for more risk-based compensation, but the proper involvement of risk management in compensation should be addressed in a compensation context, where specific purposes and roles of such involvement can be defined. The type of open-ended language used here will not help achieve either operational risk or compensation goals.

Governance (Principles 3 to 5)

The paper provides principles on the roles of the Board and senior management.

Principle 3

The discussion of the role of the Board of Directors under this Principle exceeds appropriate expectations from Boards, and should be more focused in scope to cover oversight, rather than management, of operational risk. It is asking too much of non-executive directors to go into the detail required to ensure the firm is managing "operational risks associated with new strategies, products, activities, or systems, including changes in risk profiles and priorities." This task is much more suited to the role of senior executives. With appropriate Board oversight, it would be sufficient for a senior management committee to which the Board has delegated operational risk responsibilities to perform most of these tasks.

Principle 4

This Principle makes very detailed expectations of the Board and places a heavy burden on directors to be actively involved in the operational risk management of the firm. While it is beneficial for the BCBS to be focusing on risk appetite, the expectations placed on the Board go well beyond what the industry perceive as practicable. Moreover, while the Institute agrees that the Board should approve risk appetite and tolerance statements, more guidance on what should be in an appetite statement with respect to operational risk and how it should be used would facilitate consistent implementation across the industry. The Institute is preparing a report on risk appetite, expected to be issued in June, that should contribute to development of thinking on this topic, and would hope that well understood expectations would emerge from that private-sector initiative, to be enshrined in official guidance if the need is then felt. The Institute also believes that the frequent review and monitoring of the appropriateness of operational risk "limits" should be the responsibility of senior management and not the Board, subject of course to appropriate, high-level reporting to the Board.

As well, supervisory expectations on *operational risk* appetite and tolerance statements must be differentiated from that of credit risk and market risk. It must be recognized that the nature of operational risk is different from these risks and need to be approached differently. For example, using the language of "appetite", "limits" and "thresholds" may not suit operational risk. The BCBS should offer greater insight on how meaningful operational risk limits could be constructed it that is the direction it wants the industry to follow.

Principle 5

The general theme of the paper is that the operational risk governance practices in banks should depend on the "nature, size and complexity, and the risk profile of a bank's activities." This Principle, however, tends to be more prescriptive by basically promoting operational risk committees "by country, business or functional area" and stating who should serve on said committees. Operational risk governance structures vary widely across banks, with some structures working for some but not for others. Hence, details on the governance structures should be left to the individual bank.

Prescribing too many details may just lead to contradictory or confusing requirements. For example, paragraph 37(a) allows the Board to delegate operational risk responsibilities to a management level operational risk committee, but at the same time paragraph 37(b) requires the committee to include independent non-executive Board members. As a general matter, it would not be appropriate to have Board members sit in a management level committee.

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Risk management environment (Principles 6 to 11)

The paper provides principles on identification and assessment, monitoring and reporting, and control and mitigation of operational risk, as well as on business resiliency and continuity and the role of disclosure.

Principle 6

It should be made clear that the list of tools that may be used for identifying and assessing operational risk given in paragraph 39 is not exhaustive. It should also be made clear that the use of all the listed tools is not required and would depend on a bank's circumstances. For example, while business process mapping can assist in identifying and assessing operational risk, it should be recognized that mapping all processes within an organization would require significant cost and resources, often with limited benefit. Hence, there may only be a net benefit to using business mapping process in the highest risk areas of the bank.

Paragraph 40 states that banks should identify, consider and incorporate operational costs and risks of operational loss in "internal pricing, performance measurement, and new product approval process for all significant business lines" in order to align the "risk taking incentives of individual business lines with the operational risk exposures their activities create for the bank as a whole." Further guidance should be given on how to incorporate operational costs and risks of operational loss in internal product pricing. If the intention is to do this by allocating cost of capital down to the individual product level, then the granularity required would pose a very significant challenge to banks. On the other hand, one challenge in incorporating operational risk in performance measurement is the assignment of accountability for certain operational risks. The concept of pricing in, for example, liquidity risk, is well established and important; however, the different characteristics of operational risk make it highly questionable whether a similar, pricing-based approach is appropriate; hence, further discussion between the industry and the BCBS, and perhaps guidance to be based on that discussion is in order. Perhaps the paper could use more flexible language with respect to performance measurement, and should only suggest, instead of require, that operational risks be incorporated, where appropriate.

Principle 7

The Institute recognizes that the BCBS intends to put greater emphasis on the approval process for new products, activities, processes and systems that fully assesses operational risk. However, banks operating under BIA and TSA may find it difficult to comply with these requirements given the limitations of their capture of operational risk. Since the paper is intended for all banks, care must be taken to ensure that the principles in this paper be applicable not only to AMA banks but also equally to BIA and TSA banks.

The paper states "the review and approval process should consider:… (f) the procedures and metrics to measure, monitor, and manage the risk of the new product or activity." However, in practice, there will inevitably be a lack or limitation of the relevant data required to measure the potential operational risk of some new products or activities (e.g. lack of loss experience). The paper should take this challenge into account.

Principle 8

The prescribed reporting to the Board is excessive. In particular, not all supervisory reports can usefully be provided to the Board. A distinction must be made between material and routine supervisory reports, and only the former should be required to be provided to the Board. As the paper itself notes, effective decision-making is impeded not only by paucity of information, but also by excessive amounts of information.

The requirement to include relevant external information in operational risk reports may also pose a challenge. External information on operational risk is very limited except perhaps on legal events. However, external information on legal events may come with a significant lag that it may no longer pose any potential impact on the bank.

Principle 9

The paper makes it clear that the work of the BCBS in the field of operational risk is underpinned by its 1998 paper *A Framework for Internal Control Systems in Banking Organizations*. Hence, it is understandable, and appropriate, to require banks to have a strong control environment. In doing so, however, further clarification has to be made on how this would work in practice so as to avoid confusion of responsibilities and expectations between the control function and internal audit.

Paragraph 55 states that "In those circumstances where internal controls do not adequately address risk…management can seek to transfer the risk to another party such as through insurance." This may be incorrectly interpreted to mean that insurance is a substitute for sound internal control and risk management. Although paragraph 56 clarified that risk transfer only complements and does not replace sound internal control and risk management, a similar statement should be made in the preceding paragraph.

Principle 11

The paper requires banks to make disclosures that would allow investors and counterparties to determine whether the bank is effectively managing its operational risks. In addition to this, perhaps the paper should also give more clarity on how supervisors would assess the adequacy of such disclosures.

Comments on Operational Risk – Supervisory Guidelines for the Advanced Measurement Approaches

The BCBS' Range of Practice Paper has been instrumental in identifying not only emerging effective practices in relation to AMA, but also areas of the AMA where banks require more guidelines and clarification from the supervisory community. The Institute therefore supports the BCBS's efforts to provide guidelines in these areas through the publication of this paper.

Some areas of the guidelines, however, are too broad that it is quite difficult to determine the supervisory expectation. In some areas, on the other hand, the guidelines seem too prescriptive and so specific that it seems the goal of the paper is not only to facilitate the convergence of practices to acceptable standards, but to induce convergence to one risk measurement methodology. The

Institute recognizes the difficult balance that has to be made, but in areas where more guidance and clarity is needed it should be given. At the same time, the urge to be too prescriptive should be avoided by keeping in mind that the aim is to converge to acceptable standards and not to one single model.

An important issue that needs to be reflected more in the overall AMA process is the use of judgment of business line experts. Right now, the paper mentions expert judgment mostly in relation to dependence assumptions. We believe that judgment may appropriately be used in other areas of the AMA where a purely quantitative assessment would be impossible or not sufficiently reliable owing to data or model weaknesses.

It would also be helpful to understand whether consideration was given to review of other possible risk sensitive approaches as part of a broader review of the AMA framework. In particular, the appropriateness of the "project-and-extract" paradigm (i.e. project a loss distribution over a defined horizon and then extract the metric at the desired percentile) for use in Pillar 1 capital estimation should not be universally assumed. Certainly, it is important to ensure that other risk sensitive options remain open for the industry to explore, given that AMA is very much still evolving and given also the inadequacies revealed in the similar methods used to capitalize unexpected loss for other risk types during the recent crisis.

The Institute also wishes to clarify the impact of these new supervisory guidelines on banks that are already in AMA. The paper notes that the status of banks accredited to use AMA will not be affected, but it also mentions that some AMA banks may have to amend their existing practices to reflect the paper's contents. As such, it may be appropriate for the BCBS to consider outlining the process and timeline that banks should follow in transitioning to these new guidelines, recognizing that banks currently face many demands on their IT and human resources, and need to have time to make changes in an orderly way.

The Institute's detailed comments on the three main issues in the paper – governance, data, and modeling – are discussed below.

Governance

The paper requires the three lines of defense governance structure to manage operational risk, which includes independent validation and verification as components of the third line of defense. In addition, the paper requires that banks' operational risk management function should be embedded across the banks' organizational structure, and that the banks' Board should endorse a clear statement of appetite and tolerance for operational risk.

Verification and validation

With respect to the three lines of defense framework, we mentioned in our comments on the Sound Practices paper that there seems to be an overlap between the second and third lines of defense with respect to verification and validation. In addition, the paper should not give the impression that it is advocating a specific organization structure, but instead make it clear that banks can operate under their own structures as long as the key functions that make up the three lines of defense framework are effectively addressed.

Further, paragraph 15 states that "…the independent validation process should ensure that the risk measurement methodology results in a credible estimate of operational risk capital that reflects the operational risk profile of the bank…" The independent validation of risk measurement methodology is done by a team who may have the skills and expertise to assess the adequacy and robustness of the methods used but may not be in a position to make an assessment of whether the capital resulting from the measurement methodology reflects the risk profile of the bank. The latter assessment requires qualitative judgment that should be done by senior management, who has the overall perspective of the risk management issues facing the bank.

Paragraph 57 lists the elements that should be included in the validation activity. We note, however, that item (b) repeats one of the bullets of item (a). Moreover, the review of qualitative aspects listed on this item would be more appropriate to be included in the verification activities, which generally falls within the remit of internal audit, rather than in validation. The independent model validation function, by the nature of its skill set, should normally be expected to focus only on quantitative aspects.

The paper mentions that verification and validation should be done periodically. While banks will want to perform such functions on timetables that make sense for their risk profiles and mixes of business, it could be useful to have guidance means of establishing recommended validation and verification cycles.

Use test and experience

On the issue of embeddedness, while the Institute agrees that the processes and practices underlying a bank's operational risk management framework should be embedded across a bank's organization structure, reality should always be factored in supervisory assessments and expectation of embeddedness. Achieving embeddedness takes time, especially considering the required changes in processes and methodologies.

On operational risk appetite and tolerance statements, as already raised in comments on the Sound Practices paper, a distinction must be made between expectations and language on risk appetite and tolerance statements relating to operational risk and those relating to credit and market risks. Banks, in general, are making progress but still facing challenges in implementing a risk appetite framework, especially with regard to making risk appetite and tolerance statements. As noted in the prior comments, the Institute is preparing a report on risk appetite that should be helpful. While credit risk and market risk since lend themselves easily to established quantitative metrics, this is not the case for operational risk. Hence, greater flexibility as to supervisory expectations should be afforded to operational risk in the area of risk appetite.

Data

The paper provides guidelines on supervisory expectations regarding data integrity and comprehensiveness.

Gross loss definition

The paper should clarify what other internal expenses are contemplated to be included in the "costs incurred as a consequence of the event." Typically, internal expenses related to extra work of staff

are excluded from costs associated with an event, and hence should not be included in the gross loss definition.

The objective of including "pending losses" [paragraph 85(d)] in the gross loss computation is not clear. It seems that the operational loss recording is tasked with mitigating inconsistencies between different accounting standards and/or fixing deficiencies in specific accounting standards. We suggest deleting this section so as not to overly burden the loss collection process, or at least clarifying the objective of its inclusion.

The last sentence of paragraph 87(a) is unclear. We believe the intention is not to consider timing losses as operational losses, but rather to include operational losses (e.g. litigation) that arise from timing losses. This paragraph should be revised to clarify this intent.

Internal loss data thresholds

We agree that banks are "responsible for defining and justifying appropriate thresholds for each operational risk class, both for data collection and modeling." In addition, it should also be emphasized that these thresholds should be broadly consistent across banks with the same type and nature of business activities. While this point has been raised in paragraph 105 (background), it should also be mentioned in paragraph 108 (supervisory guidelines).

We also agree that banks should regularly verify "that its choice of thresholds includes all material operational risk losses for risk management purposes." However, a systematic collection of the losses below the threshold, which is the example given, would not be an optimal way to address this issue. Other procedures should be explored, as long as these procedures are able to effectively ensure that losses below the threshold have no material effect overall.

Date of internal losses

Paragraphs 130 and 132 talk about the use of a reference date and observation period in such a way that "material loss data is not omitted" and that "limits the omission of any relevant loss data." These statements could be interpreted to mean that banks have to include all "relevant" loss data, even those occurring several years ago, no matter what reference date or observation period is chosen. We do not think that this is the intention of the paper. It should be made clear that once an appropriate reference date and observation period is chosen, there may be some "relevant" data in the past that may be excluded and that banks are not obliged to include them in the data set.

Paragraph 124 defines accounting date as the date of first financial impact. As such, the accounting date is not necessarily the same as the reserve date because legal fees are often incurred before a reserve is established. Clarification must be made as to what the BCBS would consider a more appropriate reference date for legal related losses. In addition, the requirement in paragraph 139 for banks to "capture all known legal-related exposures" does not appear consistent with the reporting example provided in paragraph 136, which focuses on the establishment of a legal reserve as the trigger event for reporting loss exposure. We recommend clarifying the requirement in paragraph 139 to reflect capture of significant litigation related operational risk exposures for which a reserve has been taken, rather than "all known legal-related exposures". We are concerned that the current language may be interpreted to include exposures not reasonably probable and may not yet be reasonably estimable.

In scenario-based modeling, potential legal-related losses are already considered in the scenario analysis and therefore included in the input parameters. This is achieved without specific details of litigation reserves being recorded and reported in the Operational Risk Loss dataset. In this case, we seek clarification whether the requirement in paragraph 133 to use a date no later than the date of reserve for including legal related losses still applies.

We are concerned with the way the paper dismisses the industry apprehension that including legal events in the loss database prior to settlement may lead to an increase in the frequency and severity of legal settlements. While the paper notes that processes have been developed "to provide information on legal events that support their AMA modeling methodology without disclosing confidential data," not all banks may have these processes in place. An assessment has to be made whether these processes can be easily adopted by all banks, and if so, whether these processes should be included as part of sound operational risk management requirements. If not, then banks' concerns are real and justified, and the BCBS should weigh the benefits of requiring a standard that, instead of appropriately capturing operational risk, may actually result in additional operational risk to banks.

Grouped losses

We also note a possible typographical error in paragraph 156. We believe the second sentence should read: "If a bank chooses **to** include…" We would appreciate clarification of this paragraph.

Modeling

The paper provides guidelines on AMA modeling issues such as granularity, distributional assumptions, correlation/dependence, and use of data elements.

Granularity

Although guidelines have been provided on the issue of granularity, some of the guidelines require more clarification from the BCBS. For example, paragraph 167 states that "supervisors should be wary when an institution uses either a very low or very high number of ORCs," but fails to define what would be considered a "very low" and "very high" ORC. In addition, paragraph 169 requires banks to be "particularly aware of the impact its choice of granularity has on the capital charge and provide evidence that the choice is reasonable." However, what would constitute a "reasonable" choice of granularity is again not defined: while prescription is not desirable, some discussion of means of assessing reasonableness might be helpful.

Paragraph 171 talks about using the choice of granularity as a gauge for capital allocation. While this concept may work nicely in theory, it may not necessarily be the case in practice where the dimensions for risk categories and for capital allocation can be quite different. For example, banks may allocate capital to minor legal entities, but these entities may not have sufficient data points to qualify as a separate risk category. We suggest therefore that this paragraph be stated more as a suggestion rather than a requirement.

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Distributional assumptions

On distributional assumptions, some of the guidelines are quite specific that they do not apply to a broad range of models that are currently used. Does this mean that banks for which these guidelines do not apply would have to change their existing models? As mentioned, the aim of the paper should be convergence of practices to acceptable standards, and not convergence to one particular model.

We are also concerned with the requirement that a single curve should not be used across all ORCs. The BCBS should be aware of the risks that choosing different distributions may entail. These risks include low robustness and model stability due to possible switches between distributions, increased model risk associated with model variety, and interpretability issues. A bank should therefore be able to choose the ORC distribution, as long as the choice is properly justified.

Correlation and dependence

On the issue of correlation/dependence, paragraph 233 could perhaps be softened by not including reference to any distribution assumption. While we agree that dependence structures should not be limited to any one distribution assumption, mentioning "Normal or Normal-like (e.g. T-Student distributions with many degrees of freedom) distributions" may raise doubts on the soundness of such distributions and may give the impression that these distributions should not be used. Banks may consider other alternatives but if these alternatives do not produce more robust estimates, nothing should preclude banks from using Normal or Normal-like distributions.

Use of the four data elements

Finally, on the use of the four data elements, paragraph 254 requires banks to scale loss amounts from external data as appropriate. This is surprising given that the industry is aware that some supervisors are against scaling external data that are used for internal risk measurement. Moreover, scaling also introduces an element of subjectivity into the modeling process, which may result in more divergence instead of convergence of the risk measures produced.

The idea that the output of a bank's AMA model, particularly those based on scenario analysis, should be a range of capital requirement estimates from where, it is assumed, management can choose from also raises some issues. This would introduce more subjectivity over how capital amount is selected from within the range. It would also lead to uncertainty regarding the allocation of capital back to the business lines. For example, it raises the question of whether each business line would also need to have its own range of capital estimates.

With regard to BEICFs, they are a key link between the "measurement and management" of operational risk and the only one of the four data elements that can be used as an ex-post adjustment to model output. Hence, it would be helpful if the paper provides more guidance on how BEICFs are and might be expected to be used in capital determination given that they could potentially be used as a means of actively managing the capital charge.

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Conclusion

The two documents reflect the "updating" of knowledge on operational risk management that resulted from the various initiatives/activities of the BCBS. The Institute supports this updating of supervisory principles and guidelines to properly incorporate new ideas on operational risk management. In doing so, however, it must be recognized that certain practices and/or methodologies work for some banks but may not work for others. Hence, the urge to prescribe the "best" observed practices/methodologies should be avoided. Rather, the focus should be on defining an acceptable range of practices/methodologies. This is especially important in the field of operational risk management where our understanding continues to evolve.

We appreciate the opportunity to provide these comments, and will be glad to elaborate further on any aspect of our comments. We also look forward to the opportunity of working together with the BCBS to further strengthen operational risk management practices across the industry.

Should you have any questions about these comments, or wish to pursue any issue raised, please contact me (dschraa@iif.com; +1.202.857.3312) or Andres Portilla (aportilla@iif.com, +1 202 857 3645).

Best regards.

Sincerely yours,