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Secretariat of the Basel Committee
on Banking Supervision
Bank for International Settlements
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Dear Secretariat,

**Sound Practices for the Management and Supervision of Operational
Risk - Consultative Document**

Thank you for the opportunity to comment on the *Sound Practices for the Management and Supervision of Operational Risk and Operational Risk - Supervisory Guidelines for the Advanced Measurement Approaches* consultation papers.

The Australian Bankers' Association is broadly in support of the changes described in the documents, and welcomes the further analysis provided. Our detailed comments are attached in tabular format.

Yours sincerely

Tony Burke

Sound Practices for the Management and Supervision of Operational Risk - consultative document

Section	Sub section	Paragraph	Comment
General/Overview			The operational risk management principles discussed in the consultative document have changed significantly from the principles issued in 2003. Of particular note is the increased focus on a bank's risk culture and the responsibilities of the Board of Directors to set sound risk foundations. These are seen as positive changes. With regards to supervisory expectations, additional guidance would be helpful.
Role of Supervisors			
Principle 1 - tone from the top and culture	The board of directors should take the lead in establishing the "tone at the top" which promotes a strong risk management culture. The board of directors and senior management should establish a corporate culture that is guided by strong risk management and that supports and provides appropriate standards and incentives for professional and responsible behaviour. In this regard, it is the responsibility of the board of directors to ensure that a strong operational risk management culture exists throughout the whole business.		<p>No issues</p> <p>The requirement for Banks to align compensation policies and incentives to business risks provides Banks with additional mechanisms to drive strong risk management behaviours. This demonstrates a clear link between risk and reward for employees on a day to day basis.</p>

Section	Sub section	Paragraph	Comment
Principle 2 - Integrated Op Risk framework	Banks should develop, implement and maintain a Framework that is fully integrated into the bank's overall risk management processes. The Framework for operational risk management chosen by an individual bank will depend on a range of factors, including its nature, size, complexity and risk profile.		No issues
Principle 3 - Directors responsibility for Control environment	The board of directors should establish, approve and periodically review the Framework. The board of directors should oversee senior management to ensure that the policies, processes and systems are implemented effectively at all decision levels.		It refers to the Board 'establishing, approving and reviewing'. Our view is that the Board should ensure Senior Management establish the framework / code of conduct etc, their role being to review it as being fit for purpose and approving it. There could be a segregation issue if the Board create, review and approve the framework. Also para 28 (e) which states that the BoD should "...ensure that management is incorporating industry best practice in managing op risk". (a) Does 'best' practice exist (what is 'best practice?') and (b) does a Bank always need to have all components of the operational risk framework as 'best practice' and is the achievable? Old sound practices referred to incorporating industry developments in operational risk management practice into a Bank's framework, which seems more sensible. That is as the industry develops and improves methodologies and techniques these should be incorporated into an organisation.

Section	Sub section	Paragraph	Comment
Principle 4 - Risk Appetite	The board of directors should approve and review a risk appetite and tolerance statement for operational risk that articulates the nature, types, and levels of operational risk that the bank is willing to assume.		<p>to assume "and gives clear guidance for the business on how it should assess its individual Risk Appetite"</p> <p>The requirement for the Board of Directors to approve and review a risk appetite and tolerance statement is significant. The ability to issue a public statement articulating the nature, types and levels of operational risk that the Bank is willing to accept presents several challenges including the disclosure of sensitive information. Whilst it is realistic to expect banks to consider the strategic direction, financial condition and risk aversion it will be difficult to put specific measurable risk appetite and tolerance statements in place.</p>
Principle 5 - Senior Management responsibility for Control environment	Senior management should develop for approval by the board of directors a clear, effective and robust governance structure with well defined, transparent and consistent lines of responsibility. Senior management is responsible for consistently implementing and maintaining throughout the organisation policies, processes and systems for managing operational risk in all of the bank's material products, services and activities, consistent with the risk appetite and tolerance.		Senior management should develop for approval by the board of directors a clear, effective and robust governance structure with well defined, transparent and consistent lines of responsibility "and ownership" .
		37	Unclear whether the Enterprise level risk committee consists of Board or Senior Management. We recommend senior management.

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Principle 6 - Identification and assessment of risks	Senior management should ensure the identification and assessment of the operational risk inherent in all material products, activities, processes and systems to ensure the inherent risks and incentives are well understood.		add 'that is visible across all relevant value chains'
Principle 7 - approval process for new initiatives	Senior management should ensure that there is an approval process for all new products, activities, processes and systems that fully assesses operational risk.		Senior management should ensure that there is an appropriate stakeholder Risk assessment /review approval process for all new products, activities, processes and systems that fully assesses operational risk.
Principle 8 - Monitoring and reporting	Senior management should implement a process to regularly monitor operational risk profiles and material exposures to losses. Appropriate reporting mechanisms should be in place at the board, senior management, and business line levels that support proactive management of operational risk.		regularly monitor and review operational risk profiles and material exposures to losses.

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Principle 9 - Control environment	Banks should have a strong control environment that utilises: policies, processes and systems; appropriate internal controls; and appropriate risk mitigation and/or transfer strategies.		No issues
Principle 10 - Business Continuity	Banks should have business resiliency and continuity plans in place to ensure an ability to operate on an ongoing basis and limit losses in the event of severe business disruption.		No issues
Principle 11 - Disclosure	A bank's public disclosures should allow market participants to assess its approach to operational risk management.		No issues.

Operational Risk - Supervisory Guidelines for the Advanced Measurement Approaches - consultative document

Section	Sub section	Paragraph	General agreement points	Areas for discussion
Overview			<p>The consultative document is a comprehensive analysis of the operational risk practices that are currently adopted globally. The coverage of governance, data and modelling provides an interesting analysis as it discusses several methodologies and the merit of each.</p> <p>Comprehensive in nature, the paper raises several useful issues. There are several sections that provide bank's with opportunities to re-assess their own procedures and determine the appropriateness of adopted methodologies. Paragraphs relating to €10,000 thresholds and grouped losses as well as references to the sound methods to connect body and tail distributions are all valid considerations for all banks.</p> <p>We support the emphasis on continuous improvement in the ORMF for the management of operational risk throughout the organisation.</p> <p>The paper gives further clarity and guidance on specific aspects, e.g. loss definitions, which enable meaningful analysis and benchmarking of data.</p> <p>Specific comments below for further discussion in relation to each section of the document.</p>	<p>The lack of internal loss data, currently available to banks, and the difficulty in identifying relevant external loss data will be a limiting factor in some of the paper's aspirational requirements:</p> <ol style="list-style-type: none"> 1. There is clear preference to use Internal Loss data to assist in estimating loss frequencies and severity distribution and the use of External Loss data to inform the tail of the loss distribution curves. 2. The paper's discussion on tailoring distributions to the types of operational risk is understandable. Ideally each operational risk category and business would have different distributions, however the lack of available historical data would again present challenges to the creation of these curves. It would also be costly and time consuming to identify tailored distributions. <p>For both of these issues, we would either ask for further guidance or an expectation that these will only be emerging techniques at this point in time, and unlikely to be used in practice for some time.</p> <p><i>Of interest were the statistics on the direct</i></p>

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				<i>contribution that Scenario Analysis, Internal Loss and External Loss data contributed to capital charges. The key learning was that despite the Committee's preference to use Internal and External Loss data to directly influence capital, 55% of the capital charge across 42 banks globally was directly attributed to Scenario Analysis. This reiterates the small amount of data available to banks to use Internal and External Loss data for distributions and the need for the Committee to provide further clarity around this.</i>
General		1-12	Supports SIGOR's goal of promoting consistency in OR management. Clarity of definitions (e.g. gross loss, recoveries, and legal events) is helpful.	
Governance	General	13	We support the three lines of defence governance structure.	

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	Verification and validation	14-16, 44-70	Agree validation should not be limited to quantitative aspects but should include data inputs, methodology and outputs of OR models.	<p>14. Agree with the concept of independent review of ORMF and ORMS. There should be recommendation on "timing /frequency" of verification and validation. It may not align with current Australian Prudential Standard 115 requirement of annual data review and tri annual model and framework review.</p> <p>14. Lot of emphasis on Line 3 defence, should consider more focus on adequate training and knowledge for Line 1 and 2.</p> <p>57a. point 4 refers to 'constructed data' which doesn't align to the four elements of the ORMF per para 20.</p>
	Use Test and experience	17-18, 71-79		
Data	General	19-20		

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Data	Gross loss definition	21-22, 80-89	82. Definition of gross loss and recoveries is helpful.	<p>83. Reason for loss being included in database (management and/or measurement). Don't know that having to capture reason for loss being included is helpful. The rules in the ORMS will capture those used for measurement only.</p> <p>87b - needs definition of 'rapid'.</p> <p>87b The definition that a rapid recovery with full recovery should be treated as a Near Miss needs further discussion.</p> <p>General – further development of industry wide taxonomies for classifying loss data would be helpful (e.g. controls, cause, product, process)</p>
	Gross versus net internal loss amounts	23-24, 90-104		101 - Recovery after 'considerable delay' - should be modelled on Gross loss needs further discussion.
	Internal loss data thresholds	25-26, 105-121	Note any threshold change to a lower \$ value would take considerable time to implement, i.e. can't accurately capture data at lower threshold retrospectively.	

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	Date of internal losses	27-29, 122-139	126. (3) concern re internal estimates of loss amounts/discoverability of documents is valid in particular as loss data is used for both measurement and management purposes.	<p>27. Date of contingent liability – question the need to capture this date and practical application of this. (e.g. rely on date of provision being raised as the date of contingent liability/first financial impact.)</p> <p>139 Comment re this concern 'lacking creditability' is noted however in legally sensitive incidents suggest reliance on date of provision/legal reserve being established. There are generally robust processes around establishment of legal provisions driven by accounting standards.</p>
	Grouped losses	30, 140-161		
Modelling	General	31-32		
	Granularity	33, 162-171	Agree if regulators are to push for more consistency on ORCs that it needs to leave some flexibility with bank to justify its choice.	
	Distributional assumptions	34-37, 172-224	Agree that several distributions should be considered when modelling severity within the SBA. It is important that flexibility exists in the approach to distribution choice, including where the choice is made by the experts.	<p>223. Further discussion is required on how the confidence interval around the risk measure should be used.</p> <p>202. The move to disallow "jumps in the probability mass function" in the distributions bank use. Whilst it would be ideal to have all our functions smooth, this goal is secondary to faithfully representing the internal/external loss data or experts scenario inputs</p>

Section	Sub section	Paragraph	General agreement points	Areas for discussion
	Correlation and dependence	38-40, 225-238		
	Use of the four data elements	41-43, 239-264		256. Uncertainty in scenario judgements and other elements to be reflected in the output of the model to produce a range of capital estimates. However acknowledgement that this is an area that requires further research and discussion including how the range will be used.