The voice of banking
& financial services

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Dear Sirs,

Supervisory guidelines for the Advanced Measurement Approaches

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 supervisory guidance for the Advanced Measurement Approach.

Key messages

Introduction - Whilst the effort to bring about convergence in practices and greater consistency in supervisory practices is noted, it would be helpful to understand whether there was consideration given to review other possible risk sensitive approaches as part of a broader review of the AMA framework itself. A possible expansion of the Basic Indicator (BIA) and Standardised approaches (TSA) to regress upon other inputs besides a revenue metric would be a natural starting point. More generally, 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 for operational risk should not be universally assumed. Certainly, it is important to ensure that other risk sensitive options remain open for industry to explore, given that AMA is very much still evolving and given also the inadequacies revealed in the similar methods used to capitalise unexpected loss for other risk types during the recent financial crisis.

Governance – The need for validation should be considered in accordance with the three lines of defence model of firms wherein second line usually undertakes validation activities.

Use Test – The reality of achieving "embeddedness" should be considered into supervisory assessments. Achieving embeddedness takes time.

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Risk Appetite / Tolerance – Operational risk appetite / tolerance is still evolving. This should be factored into consideration when comparing with risk appetite/tolerance for credit risk or market risk, which lend themselves more easily to quantification. There is a need for greater supervisory flexibility here.

Data - Industry concerns around inclusion of litigation related losses into loss databases for risk management and measurement purposes should be taken into consideration, and not be ignored as referred to in paragraph 139. It would appear that this is an area where more work would be helpful.

Modelling

- Granularity – Clarity on what would constitute a reasonable choice of granularity of operational risk categories for computation of the capital charge would be helpful. Data availability would be a limiting factor here.

- Distributional assumptions – Banks should be asked to justify their choice of curve(s) rather than be expected to have a curve for each operational risk category (and thus risk instability of model and related output).

Use of the 4 data elements - Business Environment & Internal Control Factors (BEICF) - More guidance on how BEICFs are and might be expected to be used in capital determination would be helpful. BEICFs are a key link between the “measurement and management” of operational risk and the only one of the four required elements that can be used as an ex-post adjustment to model output, or which provides a means of actively managing the capital charge.

General comments

We welcome the issue of guidance, and the assertion that “the status of banks accredited to use an AMA framework will not be affected by the observations and conclusions of the paper” (paragraph 3).

We welcome the principles-based approach, and the intention that a bank should implement the principles with regard to its nature, scale and complexity is also welcome (paragraphs 5 and 37, and principle 2). However, at times the Paper appears quite prescriptive in relation to AMA models and reads as if a single model is being proposed. Whilst greater convergence to acceptable standards is desirable the goal should not be to have a single modelling approach.

The (internationally active) 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 (paragraphs 7 and 60), a common platform, but not a one size fits all approach to operational risk modelling.

The statement that a bank’s operational risk strategy and governance should reflect its nature, scale and complexity is also welcome (paragraphs 8 and 13).

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

We would appreciate clarification of a bank’s disclosures will be assessed as enabling market participants to assess its approach to operational risk (principle 11).

Further to paragraph 22, following the issue of remuneration provisions by the Financial Stability Board (FSB), Basel Committee and European Union (by way of the Capital Requirements Directive), firms are including non-financial metrics in their appraisals of employees, and making use of bonus/malus and clawback. The use of non-financial measures predates the issue of FSB principles.

The United Kingdom's Walker Review, published in 2009 and implemented in 2010, requires firms to set up a board-level risk management committee when commensurate with the scope of the firm (paragraph 37).

Validation requires business managers with the requisite skills set to test if the model fits with the firm's risk profile. This should be a mix of qualitative and quantitative approaches. Independent validation need not necessarily mean external assessment.

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.

Conclusion

The guidance should be applied in a proportionate manner.

The Annex to our letter contains our formal response to the principles and 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

Paragraph 3: The paragraph notes that banks accredited to use an AMA framework will not be affected by the observations and conclusions of this paper but then goes on to state that some AMA banks may need to amend their practices to reflect the paper's contents. As these two points are contradictory , we wish to clarify the impact of these guidelines on AMA banks. It would be helpful to understand the process and timeframe that AMA banks should follow to transition to these new guidelines.

Paragraph 7: The last sentence in the paragraph requires further clarification. How has the Committee defined the range of effective and sound operational risk practices?

Paragraphs 15, 51 (b) and 52: It is questionable whether that the independent validation team would be in a position to ensure that the risk measurement methodology results in a credible estimate of operational risk capital that reflects the operational risk profile of the bank. Although independent validation teams can test the quantitative analysis and review results based on the input data available to them, they are not in position to determine whether the overall capital number reflects that operational risk profile of the bank. This should rather be the responsibility of senior bank management who will have the holistic view of the all risks facing the organisation.

Paragraphs 15 and 57: There is significant overlap between the roles designated for the independent model validation team and internal audit. It is proposed that where review and verification is already being performed within the scope of an internal audit, (for example, review of internal controls, use test, reporting, role of senior management and organisational aspects) that this is not duplicated by the internal model validation team.

Paragraphs 16 and 56 (j): These paragraphs refer to "Periodic assessments" – what is the recommended validation and verification cycle?

Paragraphs 18 and 77: These paragraphs state the requirement of a bank's board of directors to endorse a clear statement of operational risk appetite and tolerance. In line with feedback provided to the Committee's Sound Practices paper, 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.

Paragraphs 36 – 37 and 172 – 224: In the context of AMA modelling approaches, the paper is highly prescriptive. It makes a number of assumptions regarding the type of modelling approaches currently in use. For banks with a modelling approach outside of these starting assumptions, it is unclear as to how this guidance could apply without a fundamental change of model.

Paragraphs 54 and 60: This paragraph states that the AMA validation team should be independent, meaning that they cannot influence the development and implementation of the AMA framework. Yet this is contradictory to the last bullet of 57 (a) which notes that the validation team should be part of any new or modified model approval process. It also contradicts 57(c) which notes that issues and recommendations arising from the validation process should be appropriately considered and acted upon.

Paragraph 57: This paragraph lists the elements that should be included in the validation exercise. It includes quantitative as well as qualitative items. We recommend that qualitative items should be part of the verification exercise, not the validation exercise. It is also noted that the verification exercise requires unfettered access and would be extensive i.e. verifying every single Operational Risk activity – this may not be practical and staged verification may be more appropriate.

Paragraph 57 (g): Please clarify what is meant by “the relationship between the model’s inputs and outputs are stable”?

Paragraph 89: Internal expenses should only be included if outside business as normal operating costs.

Paragraphs 128 – 139 and 186: The supervisory view surrounding the recognition and recording of legal provisions is noted, however some banks would like to re-assert their litigation department’s concerns that disclosure of reserve information on an individual case basis could lead to the identification of material issues and impact their ability to appropriately resolve litigation. It is proposed that such losses should instead be captured via scenario analysis as described in Paragraph 135, which removes the need to record specific losses in risk systems.

Sections from 128 to 139 do not adequately distinguish between general legal losses resulting from operational risk events and those that are significant litigation-related operational losses where a reserve has been taken that should be considered for capital modeling purposes.

The supervisory guidance should clarify that banks should capture exposures only for significant litigation-related operational loss events for which a reserve has been taken. Paragraph 133 should be revised as follows: “Consistent with other operational risk losses, a bank should use a date no later than the date of reserve (accounting date) for including significant litigation-related operational losses/exposures for which reserves have been taken as an input in its AMA model.”

Furthermore, we fundamentally disagree with the statement in paragraph 139 that banks’ concerns regarding discovery of privileged data “lacks credibility.” In common law jurisdictions, such as England and the United States, where parties to litigation are subject to extensive discovery obligations, this is a very real concern. Such information may be privileged and confidential, as well as potentially subject to work-product protection in the United States. Provision of such information in an operational risk measurement and/or management system, could waive such privileges.

Unless processes at every bank enable loss data to be provided on an anonymised basis, a bank's view of its potential liability in a particular case could indeed be revealed through the discovery process, thereby increasing the bank's legal and operational risk. The last sentence of paragraph 139 should be revised to state "As a result, for capital modeling purposes, a bank should capture significant litigation-related operational losses/exposures for which reserves have been taken.

Paragraphs 134 – 6: The intention is sound, but there are practical challenges. The guidance to put aside reserves may be counter-productive, especially in the United States, and lead to an increase in losses.

Paragraph 139: The phrase "this concern lacks credibility" is unfair. There is a presumption of guilt on the part of banks in these processes.

Paragraph 176 and beyond: It appears that regulators are trying to get all firms to use the same model by way of indirect guidance and the range of practice detailed in this paper. It's not clear what supervisors are trying to achieve with the distributional assumptions.

Paragraphs 215 and beyond: These sections are useful for guidelines and examples of practice, but they do reduce the ability to improve models.

Paragraph 223: Do supervisors mean anything in addition to this paragraph? Stress testing is used in the capital planning process.

Paragraph 227: It's not clear what supervisors mean.

Paragraphs 252 – 254: Scaling external loss data introduces into AMA modelling a number of additional assumptions and choices. The choice of scaling factors and loss types to scale can undermine loss data integrity and could cause further divergence between firms. As an example, a rogue trading loss size may have no correlation with an institution's risk appetite, balance sheet scale or revenue size, yet one firm may choose to scale this data point by factor A, another firm by factor B and yet another firm may not choose not to scale it at all.

Paragraph 254: This wording suggests that scaling is a requirement when using external loss data. This is surprising as there is no industry consensus on scaling methodologies and a number of regulators are believed to have reservations about the appropriateness of scaling of external loss data.

Paragraph 256: The scenario process will need clear validation. There is a degree of uncertainty in any capital modelling approach and an appropriate level of conservatism should apply to all capital modelling approaches not just those using scenarios as inputs.

Paragraph 257 (c): We would prefer the word "qualified" deleted.