



FEDERATION
BANCAIRE
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*Banking supervision
And Accounting issues Unit
The Director*

Paris, February 24th 2011

French Banking Federation comments on the BCBS Consultative Documents on “Sound Practices for the Management and Supervision of Operational Risk” (BCBS 183) and “Supervisory Guidelines for the Advanced Measurement Approaches (BCBS 184).

Dear Sir,

The French Banking Federation (FBF) is the professional body representing over 430 commercial, cooperative and mutual banks operating in France. It includes both French and foreign-based organizations.

The French Banking Federation appreciates the opportunity to provide its views on the issues raised in the Basel Committee consultations.

First, we feel important to refocus the role of the board in the risk management process.

Then, we believe there is a need to underline the specificity of operational risk compared to other risks. Indeed because of its heterogeneous nature, it is difficult to quantify risk appetite. In this context, the notion of risk tolerance is rather preferred.

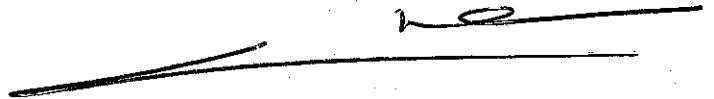
Finally the FBF reminds that, when modelling operational risk, the final aim should be to develop healthy, understandable and moderate risk management.

You will find in the annexes attached our general comments and our concerns to the issues raised in the consultative documents (BCBS 183 and BCBS 184).

**Mr Stephan WALTER
General Secretary
Secretariat of the Basel Committee
on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland**

We thank you for your consideration of our remarks and remain at your disposal for any questions or additional information you might have.

Yours sincerely,

A handwritten signature in black ink, consisting of a series of loops and a long horizontal stroke, positioned above a solid horizontal line.

Jean-Paul Caudal

Annex I: Comments on BCBS 183

I. Principles for the management of operational risk

Points 13 to 16: We fully adhere to the three lines of defence framework. We would suggest defining the responsibilities of the third line as "verification and validation" instead of "independent review and challenge". This would help to bring consistency with the BCBS 184 document and to clarify the respective role of the second (in charge of an independent challenge) and third lines of defence.

II. Governance: the role of board of directors and senior management

The board of directors

Principle 3: 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.

We disagree on this proposal in particular where a two-tier governance model is in place, as it is for instance the case in France. The board of directors has a supervisory but not an executive function while the management board carries out the executive function. Therefore, on the issue of governance raised in the consultation paper, our position would be to grant the executive body the responsibility to establish and periodically review the operational risk framework. The executive management is fully responsible of the company's actions; the board of directors shall not interfere with the responsibilities of the executive management, however it assesses its efficiency and eventually passes a vote of non confidence and dismisses it. The board of directors is in charge of approving the executive management proposals and overseeing senior management to ensure that the framework is implemented. It must have a thorough vision of the risks run by the bank. It can act through a "Risk Committee" whose members are members of the board of directors.

The absence of distinction between the responsibilities of the board in its supervisory function and the executive management leads to a real confusion and tends to implicate the supervisory function in the management of the institution on a wider range of subjects. This trend is neither efficient nor realistic, as the principle of checks and balances is not respected and the internal control framework is not appropriate.

Principle 4: 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.

We agree that the board of directors is responsible for approving the **overall** risk appetite statement for operational risk. But the role of the senior management should be to define and review the natures, types and levels of operational risk that the bank is willing to assume.

Moreover, we believe that the word "risk appetite" is not relevant for operational risk. We would prefer to use "**risk tolerance**" for operational risk.

We fully agree with the fact that operational risk is inherent in all banking products, services and activities; moreover that effective management of operational risk is a fundamental element of a bank's risk management program. Consequently, banks should develop, implement and maintain a framework fully integrated in the bank's overall risk management process.

Nevertheless, the nature and complexity of operational risk makes it slightly different from the other risks. As a matter of facts, operational risk in the financial sector is a heterogeneous family of risks. It is not related with transactions as credit or market risks but mainly by processes and external events. It includes events as various as fraud, business disruption, processing errors, or business malpractice, ... It is endogenous to the institution; it is linked to the nature and the complexity of the activities, to the processes and the systems in place, and to the quality of the management and of the information flows, to name but a few factors.

This heterogeneous nature makes it very difficult to model and measure. Unlike market or credit risk, the assessment of operational risk still remains a delicate endeavour, due in part to the intrinsic difficulty of the exercise. It cannot rely purely on quantitative data but should include expert judgments.

Beyond the model, limits are very difficult to set up. Regarding credit risk, the maximum loss is the nominal value of the credit; regarding market risks, loss can be assessed within a range of market values. Unlike these risks, the maximum loss regarding operational risk may have no limit (e. g. natural disasters impacts or rogue trading) and there is most of the time, no means to come back within the limits, just as closing a position in credit or market risks.

Finally, while risk appetite is a key issue regarding credit or market risk management, it is not relevant regarding operational risk. Thus, financial institutions have no risk appetite or tolerance for a natural disaster or an internal fraud; while a risk tolerance may be defined regarding execution errors or client litigation for example.

Senior Management

Principle 5: 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.

We agree on the responsibilities assigned to the senior management. However, we would change the last sentence as follow: "*Senior management is responsible for consistently implementing and maintaining ... consistent with the **risk tolerance***".

Annex II: Comments on BCBS 184

I. Governance: verification and validation - § 44 to §60

The guidelines are almost exclusively focused on the role of the third line of defence; we consider beneficial that the role of the other actors be developed.

The third line of defence has undoubtedly a critical role to play in the verification and validation of the overall framework, covering both first and second lines of defence. But this role is by nature, more or less, few and far.

We consider the role of the following actors should be re emphasized:

- The experts, which are part of the first line of defence. Most of the inputs in ORMF and ORMS cannot just be purely quantitative data. There is always a need for qualitative factors that will be synthesized through expert judgment.
- The second line of defence, namely the corporate operational risk function (CORF)¹. The CORF should be asked to review and challenge, on a regular basis, the inputs and outputs of the risk management, risk measurement and reporting systems, as the BCBS 183 § 15 rightly mentioned. The independence of CORF from the businesses it oversees, should also be underlined.

Furthermore, the document could set guiding principles for the relationships between actors, that is:

- a formal escalation process in case of disagreement between the first line and the second line of defence on risk management, risk measurement and reporting systems ;
- a formal endorsement of the inputs² and outputs of the risk management, risk measurement and reporting systems, by the management, and in case of disagreement between the first and second line of defence, by a more senior level of management than the one directly involved.

All these points could be introduced in a paragraph to be inserted before § 55, that could be formalized as:

55a. The Bank should develop a framework defining the respective role of the first and second lines of defence in the operation of the ORMF/ORMS. The first line of defence should implement and operate the ORMF / ORMS as defined by the second line of defence, using quantitative data and more qualitative ones that could be summarised by experts' judgments.

The CORF, operating independently from the businesses they oversee, should review and challenge, the inputs and outputs of the risk management, risk measurement and reporting systems.

Inputs and outputs from the ORMF/ORMS should be formally endorsed by the management. In case of disagreement between the CORF and the business lines, a formal escalation process should be initiated.

Furthermore the expert judgment should be considered as an input in the decision making process in many elements, especially in several § relating to modelling.

¹ In the BCBS 183, the function is named CORF when in the BCBS 184, the term Corporate Operational Risk Management Function is generally used. We suggest aligning both documents on the CORF acronym.

² And especially the expert judgments.

II. Data - § 80 to § 161

Specific comments

Points 81 (also mentioned in §11): The absence of common definition for gross loss, net loss and recovery is clearly a gap that should be fulfilled as quickly as possible to ensure transparency and enable helpful comparisons within the industry.

Point 87: Considering rapidly recovered loss events as a gross loss event followed by a recovery event (which is an independent occurrence as rightly mentioned in §84) seems to be the most appropriate method as the alternatives ("near miss", net loss) entail some information loss, lack of transparency and potentially biased interpretations of external data within the industry.

Point 89: Including near misses, gains and opportunity costs to operational risk appreciation is a good idea from a qualitative point of view but it is not always relevant from a quantitative point of view: oppositely to market risk, we use statistical laws that only model losses and not gains. Including gains and near misses will raise the frequency parameter and by the way lead to non realistic huge 99.9% capital.

Point 105: we suggest the following wording:

[...] *"The appropriate threshold may vary somewhat between banks and within a bank across business lines and/or event types. However, particular thresholds should be broadly consistent **with the type and nature of the business activity.**"*

Points 135 & 136: Risk appreciation for legal events is made by provisions into the database, then fitted with statistical laws. If we build a new scenario for each legal case, without using an SBA approach, we will compute several 99,9% quintiles which will lead to a non realistic huge aggregated capital.

Point 156 (also mentioned in § 30b): We do not agree that small losses grouped together have to be controlled in order to prove their low impact on distributions. Actually, for some event types like external fraud (card fraud), the distribution is described more by the small grouped losses than the few higher losses which do not give an accurate point of view on the underlying risk profile. In that case the higher losses may be excluded from the data set and inserted as specific scenarios.

III. Modelling - § 162 to § 264

General comments

Modelling operational risks is a complex activity essentially because of the wide range and features of risks and the low number of data unlike market and credit risks. Indeed, these last three years sophisticated statistical model have been developed. But the research of development should not hinder the final purpose/objective. The juxtaposition/ combination of multiple models could distort the final results and create inconsistency. In our opinion, it is critical to have a sound, coherent and mastered model which displays stability through the time even if there is a need to refine it regularly.

The consultation paper suggests various possible solutions. However it should not spur/encourage banks to rush into complex and too heterogeneous models to the detriment of quantifiable inputs by specialised businesses, a good understanding of the general functioning and acceptable results. The final aim being to develop healthy, understandable and moderate risk management.

A key issue is to get buy-in from the management, meaning models should remain simple and understandable, and be not over sophisticated, even if statistically richer. It is of the utmost importance to keep a pragmatic approach and to take into account the judgement of business experts. The judgment of business line experts should be reflected in the overall process of AMA governance. Using judgment for different types of inputs used in the modelling may present its own challenges, as eliciting accurate but subjective estimates may be rather difficult.

Specific comments

Point 167: the sentence “A high number of ORC’s [...] data threshold” is confusing. We do not understand why the data threshold is mentioned since it is usually an amount used for severity rather than a minimum number of losses for statistical law-fitting.

Point 173: it is inappropriate to make a comparison between Operational risk and Credit risk because the two approaches are completely different. However we agree with the need to model an annual loss for both risks.

Point 182: a longer observation period implies naturally a higher number of losses and makes it easier to model severity. However doing this, there is a risk to create heterogeneity because the risk profile changes through the time: banking activities change, some processes disappear and new loss events are taken into account. This heterogeneity issue should be considered in this paper due its significant impact on statistical assumptions.

Thus, we suggest the following wording:

*“The Basel II Framework requires banks to base their internally generated operational risk measures on a minimum historical observation period of five years **(three years when an institution first moves to an AMA)**. If relevant, for certain ORCs with low frequency of events, an observation period greater than five years may be necessary to collect sufficient data to generate reliable operational risk measures and ensure that losses are included in the calculation dataset.”*

Point 187: Could you define more clearly the meaning of the parenthesis “unique for the different ORCs”

Point 191: We suggest the following wording:

“If relevant, a bank should consider applying appropriate adjustment rates on data when inflation or deflation effects are material. For example, when the observation period for a specific ORC is extensive (eg 15-20 years) due to the infrequent occurrence of loss events and loss date series is not stationary, the adjustments on the oldest loss amounts due to discount effects may be the solution to recover the stationarity. The relevancy can be justified by either statistical means or expert judgment.”

Point 194: this point is relevant for the internal loss data but it is not always true especially for scenarios which are generally based on little statistical information.

Point 195: the four criteria given are relevant and describe well how the probability distribution should be defined. They should not be in contradiction with the rest of the paper whose content reflect more a theoretical approach rather than a practical point of view on operational risk modelling.

Point 196: regarding paragraph (a), we would like to precise that an Explanatory Data Analysis helps understanding the statistical profile but it is far more complicated to use it when selecting the probability distribution. Banks who started using this kind of approach finally changed their mind and went back to a single (or maybe two) law(s) in order to respect the criteria defined in point 195.

Point 197: We suggest the following wording:

*"In order to examine the statistical properties of each ORC (ie homogeneity, independence, stationarity), a bank **may** use statistical tools which include, but are not limited to, scatter plots, time series autocorrelation plots, empirical distribution plots, histograms and regression analysis, when appropriate. Other tools, such as p-p plots, q-q plots and mean excess plots **may** provide additional evidence on the type and shape of the probability distributions which better represent the data. "*

Point 201: We suggest the following wording:

*"In such cases the use of so-called sub-exponential distributions **can be useful when relevant**. Distributions, which sometimes have a higher number of parameters than light tailed curves, can better represent the shape of the data in the tail (other than their skewness in the body) by allowing estimates of parameters that do not depend on the higher order statistical moments. "*

Point 209: This cycle should not be too brief for operational reasons. We feel important to precise that the model must be stable; it is not acceptable to change the methodology every year. This would even be impossible given the provisions of the CEBS / EBA Consultative Paper 45 on AMA changes whereby prior supervisor approval would have to be requested.

We suggest the following wording:

*"A bank should have a regular cycle to verify assumptions underlying the probability distributions they have selected. These verifications may follow the criteria and tests a bank's use in the selection of the probability distribution. If assumptions are invalidated, alternative methods should be tested and implemented. However, any change should be properly justified. **For instance, after suffering one or more significant losses in an ORC, a bank should provide proper justification of a probability distribution recalibration based on both quantitative and expert elements.**"*

Points 212 to 214 (also mentioned in § 36, 37): Using a single law for scenarios may raise some scepticism, but this intuition has to be discussed regarding the statistical information available for scenarios: there is usually very few data to characterize scenarios which concerns extreme and rare events, so the distributional shape for the distribution body is hard to determine.

The operational risk profile should be driven by the data input into the model, in that case by the orders of magnitude of the scenario analysis, and not emphasized by a tailored severity law.

The single-law hypothesis is somewhat useful as it lets the risk management and the business having a better understanding of the 99,9% percentile evolutions linked to scenarios, or comparing them through a homogeneous framework.

Furthermore, apart from being complex, this approach, whereby statistical laws may be regularly tested and changed each time it needs, does not seem to be consistent with the provisions of the CEBS / EBA Consultative Paper 45 of the dating December 2010. This paper asks for prior supervisor approval for every significant or major change in the model. The definition of these changes being quite extensive, it would mean each time an institution wants to change a distribution law of a scenario, it would need to get supervisor's prior approval.

The shape of SBA distribution and its parameters should be properly justified. The justification should be based on quantitative and experts elements.

Points 215 & 217: the aggregated loss distribution depends essentially on the severity distribution but also on the frequency distribution. Due to the short period of observation, the latter is imprecise and it is practically impossible to measure its accuracy.

Thus it is not so simple to ensure that risk measure is stable and precise. This fact is highlighted by the high value of the VaR's quintile: 99,9%. Moreover, if the severity distribution has to be flexible (in order to take into account the new tail losses), the resulting aggregated loss distribution will not be so stable.

Point 223: We suggest the following wording:

*"A bank should recognise that the estimated capital charge is inherently uncertain due to the heaviness and scarcity of operational risk losses in the tail region. **As such, the particular cases are to be defined by the expert's judgment where the bank should explicitly recognise this variability in their estimates and estimate an appropriate confidence interval around the risk measure.**"*

Point 239 (mentioned in §41): We suggest the following wording:

*"The AMA of a bank requires the use of **up to** four data elements which are [...]"*