ZENTRALER KREDITAUSSCHUSS

MITGLIEDER: BUNDESVERBAND DER DEUTSCHEN VOLKSBANKEN UND RAIFFEISENBANKEN E.V. BERLIN · BUNDESVERBAND DEUTSCHER BANKEN E.V. BERLIN
BUNDESVERBAND ÖFFENTLICHER BANKEN DEUTSCHLANDS E.V. BERLIN · DEUTSCHER SPARKASSEN- UND GIROVERBAND E.V. BERLIN-BONN
VERBAND DEUTSCHER PFANDBRIEFBANKEN E.V. BERLIN

Via e-mail: baselcommittee@bis.org

Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
4002 Basel
Switzerland

25 February 2011
Burgstrasse 28
AZ ZKA: BASEL
AZ BdB: C 17 - Sz/Ha/Gk

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

Dear Madams, dear Sirs,

The Zentraler Kreditausschuss (ZKA), which through its five member associations represents more than 2,300 banks in Germany,[1] is grateful for this opportunity to respond to the Basel Committee regarding its consultative document "Operational Risk – Supervisory Guidelines for the Advanced Measurement Approaches" and to express the position of the German banking sector.

General comments

We support the initiative of the Basel Committee to refine, and to internationally harmonise, the Advanced Measurement Approaches (AMA). The consultative document indeed makes a significant contribution toward this objective. However, because it does not address the entirety of the AMA but rather only certain elements, we would note that the scope of the paper is rather more

[1] The Zentraler Kreditausschuss (ZKA) is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public-sector banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks financial group, and the Verband der Pfandbriefbanken (vdp), for the Pfandbrief banks.

. . .

limited than is implied by the title “Supervisory Guidelines for the Advanced Measurement Approaches”. We would suggest, as this initiative moves forward, that additional aspects be drawn into the document toward the ultimate goal of achieving global convergence of the AMA in their entirety.

Comments on particular items

Governance

In paragraphs 13 and 45, as well as in paragraph 13 of the parallel consultation document “Sound Practices for the Management and Supervision of Operational Risk”, reference is made to the “three lines of defence” for sound operational risk governance. However, the wording of the third of these is alternately called “an independent review and challenge”, “independent verification and validation” and “independent review”, which may cause unneeded confusion. We would therefore suggest that the third line of defence be uniformly referred to as an “independent review”.

In paragraphs 44 through 70, the Basel Committee outlines detailed requirements for AMA verification and validation. These differentiate between the operational risk management framework (ORMF) and the operational risk measurement system (ORMS), which is a component thereof. Following the requirements for ORMF verification in paragraph 51 (a), paragraph 51 (b) goes on to define the scope of ORMS validation, with the latter text addressing essentially quantitative aspects (“inputs, assumptions, processes and outputs” along with “methodology”). The accompanying Figure 1 aims to depict these relationships visually.

Within the green ORMS box in Figure 1, however, the phrase “Methodologies, Policies, Processes & Governance” greatly exceeds not only the scope of paragraph 51 (b) but also the scope of validation of existing practice under the Basel II framework, which encompasses essentially all quantitative components of the AMA and whereby all components of the ORMF, both qualitative and quantitative, are subsequently reviewed in the verification process. This existing arrangement is, in our view, effective and avoids duplication of effort. We would further note that “Policies & Procedures” and “Governance” appear a second time within the outer blue portion of Figure 1 (verification of OMRF). We would ask that Figure 1 be adjusted so that it is consistent in this regard with 51 (a) and (b).

The procedures for verification and validation should, according to paragraphs 54 (a) and 60, be performed by bank staff who are independent, are not part of the operational risk management

function, and do not have influence on the development, implementation and operation of the AMA framework. This would imply to us that banks would now need to establish an independent validation unit. The prevailing current practice among German banks, however, is for the validation work to be performed by a unit which is organisationally part of the central operational risk function. The validation itself is then subjected to the verification procedure, which is conducted by internal audit. Internal audit is, needless to say, strictly independent of the operational risk function. This arrangement, in our view, is sufficient to ensure the impartiality and correctness of validation. We thus regard the absolute requirement in paragraphs 54 (a) and 60 that staff involved in "validation work" not be organisationally connected, or otherwise involved, with operational risk management as an overreach which would, at least in German banks, be quite disruptive. We therefore believe, insofar as the validation work is subjected to verification, that this requirement is unnecessary and move for it to be stricken from paragraph 60 as follows: "…**Independence**: *The bank's verification and validation functions should provide independent assessments and opinions, while avoiding improper influence from those units being reviewed.* ~~*Personnel conducting verification and validation work should not be involved in the development, implementation or operation of the ORMF or ORMS processes or systems being reviewed, or be subordinate to the units under review.*~~ *Bank staff performing the verification and validation should be impartial and prepared to challenge management's views and conclusions regarding any aspect of the AMA framework.*"

We regard the detailed and separate enumeration of AMA verification requirements in paragraph 56 as unnecessary because a suitable framework of supervisory regulations is already in place governing verification. Additional requirements should, in our view, be confined to validation.

Paragraph 57 defines the nature and scope of validation activities. We would note, however, that the scope of validation here goes far beyond the definition of validation in paragraph 51 (b), which we regard as appropriate. As discussed above, validation should, in our view, focus entirely on the quantitative aspects of the AMA, thus avoiding duplication of efforts. We would ask, therefore, that the fifth bullet point under sub-paragraph (a) along with sub-paragraphs (b) and (e) be stricken. It should further be noted that sub-paragraph (b) is a duplication of the fifth bullet point under (a).

Paragraph 64 calls for banks to establish "a broad strategic plan that governs the verification and validation of [their] ORMF and ORMS". As already mentioned, it is established practice among German banks for internal audit to undertake verification and for another unit to perform the validation work relating to the quantitative aspects of the AMA. This validation is, in turn, subject

to verification. We are concerned that a single strategic plan encompassing both verification and validation would compromise the strict independence of the internal audit function. We would thus ask that paragraph 64 be modified accordingly.

Among German banks, verification generally falls within the purview of internal audit. The requirement in paragraph 66 (g) for “audit involvement or oversight”, which would seem to imply that verification not be performed by audit, thus presents an issue requiring clarification. More broadly, however, because we are of the view that there is no need, within scope of this document, to create a separate or additional set of AMA verification requirements beyond those already established, we would move to strike the entirety of paragraph 66.

Data

The paragraphs within the first sentence of paragraph 20 would seem to be incorrectly grouped. The sentence should read:
“…*AMA operational risk data can be grouped into the following four categories: (1) internal loss data, (2) external data, (3) scenario data and (4) data related to a bank’s business environment and ~~(4)~~ internal controls*.”

Paragraph 85 (b) provides that, in computing gross losses, not only external but also internal costs directly linked to the operational risk event should be included. At the present time, internal costs are, because of the effort and complexity of internal cost allocations, generally not included in gross loss computations. We would thus move to strike the reference to internal expenses for gross loss computations:
“*(b) Costs incurred as a consequence of the event that should include ~~internal and~~ external expenses with a direct link to the operational risk event and costs of repair or replacement*…”

Further in paragraph 85, we find the description of pending losses under sub-paragraph (d) rather confusing, particularly the reference to variability “across institutions or countries”, e.g. due to differing accounting standards. We interpret this to mean that the handling of pending losses, and their inclusion in operational risk loss, may likewise vary between countries or banks. We would ask you to review this paragraph and, to the extent that we understand it correctly, clarify the text according.

. . .

Within the definition of timing losses under paragraph 87 (a), the last sentence is, in our view, not entirely clear. We would suggest to replace it with the following alternative formulation: "~~*However, material "timing losses" due to operational risk events that span two or more accounting periods should be included in the scope of operational risk loss when they give rise to legal risk.*~~ *Timing losses should be considered as operational risk events without an associated loss. However, an initial timing loss may lead to an operational risk loss (e.g. litigation), which must be recorded. Also, it is recommended to record timing losses separately for risk management purposes.*"

Modelling

In paragraph 133, the term "date of reserve" is parenthetically defined as "accounting date". Earlier, in paragraph 124, this same term "accounting date" is parenthetically defined in terms of "first financial impact" . Where legal events occur, these often involve financial outlays, such as for legal expenses, prior to the date upon which reserves are taken ("date of reserve"). Thus, if one is to understand "accounting date" as the date of "first financial impact", it would lie before the date of reserve. In order to avoid confusion, we would suggest that the parenthetical references to "accounting date" in paragraphs 133 and 136 be stricken.

Paragraph 135 requires that, because legal exposures can change over an interim period, banks employ a scenario approach during this time. It is our view that, while care must be taken in appropriately estimating potential losses from legal events, these estimates are not necessarily best generated through scenario analysis. There should be latitude here to use other appropriate estimation procedures, and we would ask that paragraph 135, as well as the example in paragraph 136, be modified accordingly.

Where banks use internal loss data, paragraph 155 stipulates that the occurrence date, rather than the discovery date, should be utilised in the modelling of dependence/correlations. It would seem to us that this provision should be moved to the section "Date of internal losses", where it logically belongs.

Where a bank aggregates small losses which are not causally related for data collection and registration purposes, it should, according to the first sentence of paragraph 156, not include these in its calculations for capital requirements. The intent of the second sentence, as we understand it,

is to permit banks to waive this exclusion if they so choose, i.e. to include them in the calculations. The word "not" would thus seem to be in error:
„*…If a bank chooses ~~not~~ to include these losses in its calculation dataset, it should demonstrate that the use of this type of grouped losses does not materially distort the capital requirements calculation.*"

Paragraph 200 entirely excludes as "unacceptable practice" the use of empirical curves to estimate tail regions because of the "inability to extrapolate information beyond the last observable data point". In footnote 17, however, the Basel Committee goes on to describe an exception. In our view, provisions for such exceptions should be incorporated within the regulations and not relegated to footnotes, where they are likely to be overlooked. We would thus suggest that this footnote text be moved into the main body of paragraph 200 and augmented along the following lines:
"*…In particular, when the data are medium/heavy tailed (therefore very dispersed in the tail), the use of empirical curves to estimate the tail region should be an exception for single matrix cells. In general the same principle should apply to AMA models based on scenario analysis (SBA). Just in limited cases, for example when the biggest data point is demonstrated to be larger or equal in amount to the event that occurs less than once in 1000 years, the use of empirical curves to estimate the tail may be accepted in SBA models. Due to the inability to extrapolate information beyond the last observable data point it is only acceptable if the far tail is based on well constructed scenario data and the bank has set strict standards for the use of empirical tail distribution. That could be for example: The tail contains sufficient high data points that are far outside the internal loss data. It has been properly approved that the maximum data point is a realistic boundary for a single event (e.g. according to portfolio / transaction limits). Stability analysis has been performed and is well documented.*"

Paragraph 221 states that the "measure (and the overall AMA model) fulfils the monotonic principle of risk, which can be seen in the generation of higher capital requirements when the underlying risk profile increases", while paragraphs 35 and 215 likewise call for risk measures to be monotonic. This statement, in our view, is not strictly correct. An increase in losses does not, in all cases, result in higher computed capital requirements. We would thus move that paragraph 221 be deleted in its entirety and the other two paragraphs be adjusted accordingly.

Under paragraph 233, dependence models should not be limited to normal or normal-like distributions because these tend to underestimate dependences among tail events. The Gaussian distribution, however, is a proven and widely understood tool for modelling loss frequency

dependencies in LDA models. In 2009, roughly one half of the banks using AMA reported that they were using the normal distribution. The requirement to additionally use other, significantly more complicated statistical frameworks would be, for many institutions, an unrealistic demand. In addition, banks do not necessarily have the needed historical loss data. We would therefore propose that, to the extent that banks are not in a position to implement statistical models which better capture tail dependencies, the Gaussian copula continue to be recognised as a distribution function subject to the provision that tail dependencies be regularly and adequately reviewed (or validated). We would propose that the text of paragraph 233 be modified as follows:
"*Assumptions regarding dependence should be conservative given the uncertainties surrounding dependence modelling for operational risk. <u>Dependence structures, based on Normal or Normal-like (eg T-Student distributions with many degrees of freedom) distributions, may underestimate the amount of dependence between tail events. However, the Gaussian copula is acceptable if tail dependency is reviewed to some extent. Alternatives with better performance in tail modelling should be preferred if possible.</u>*"

According to paragraph 237 (essentially duplicated in paragraph 40), banks should perform sensitivity analyses and stress testing on the effect of alternative dependence assumptions on their operational risk capital charge estimates. Assumed dependence structures should, in our opinion, be regularly validated by banks using an appropriate methodology, with the choice of specific methodology left to the judgment of the individual bank. We must underscore that sensitivity analyses and stress testing are very demanding and costly methods of validating dependence structures.

Paragraph 42 outlines the four data elements used in the AMA for calculating operational risk capital charges, which are internal loss data (ILD), described in sub-paragraph (a); external data (ED), described in sub-paragraph (b); scenario analysis (SA), described in sub-paragraph (c); and business environment and internal control factors (BEICFs), described in sub-paragraph (d). Under the existing Basel II framework, the way these data elements are combined and utilised is left to the discretion of the bank. Paragraphs 251 (for ILD), 252 (for ED), 255 (for SA) and 259 (for BEICFs) go even further in stipulating how these data elements are to be applied. In recognition of the fact that the current state of industry practice in measuring operational risks in still in a formative stage, we strongly believe that the flexibility currently provided to banks in this respect should not, at this time, be curtailed. For the time being, the ways in which banks actually apply these four data elements should remain under close observation.

Paragraph 257 presents some rather extensive and detailed requirements for scenario analysis. Sub-paragraphs (b) and (d) go so far as to implicitly mandate a “scenario generation workshop”, which we regard as only one of various possible mechanisms for performing scenario analysis. In our view, sub-paragraphs (a), (f), (g) and (h) provide sufficient general guidance for scenario analysis frameworks. We would therefore ask that the other five sub-paragraphs be deleted.

Should you have any questions or wish to discuss these comments and suggestions further, please feel free to contact us.

Yours sincerely,
on behalf of the Zentraler Kreditausschuss
Association of German Banks

Dirk Jäger Anja Schulz