AUSTRALIAN BANKERS' ASSOCIATION INC.

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Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
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Switzerland
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Dear Sir/Madam,

Consultative Document: Operational risk – Revisions to the simpler approaches

The Australian Bankers' Association (**ABA**), on behalf of its members, appreciates the opportunity to provide feedback on the Basel Committee's Consultative Document, "Operational risk – Revisions to the simpler approaches" (**Consultative Document**). The ABA is supportive of the Basel Committee's review of the Standardised Approach (**TSA**) to address issues in the current formula. The ABA agrees on the need to balance risk sensitivity with simplicity and comparability in the approach and would also support an additional objective of encouraging better risk management practices.

The ABA's view is that the revised Standardised Approach (**SA**) leans heavily towards simplicity rather than risk sensitivity and does not encourage better risk management practices. This may be an appropriate compromise for the broad spectrum of entities that will utilise a SA, but it is not the optimum approach for all entities, in particular institutions with the ability, experience, modelling capability and data to develop a more risk sensitive approach.

For this reason, it is critical that the Advanced Measurement Approaches (**AMA**) is not only retained as an option for calculating operational risk capital requirements alongside the revised SA, and its development is actively promoted. If benchmarking thresholds based on the revised SA are applied to the AMA, such benchmarks should be set at a level which further encourages continued investment in risk management to develop AMA approaches.

A number of Australian banks have been accredited with AMA through the broader implementation of Basel II in 2008 and many of the advances in operational risk management have resulted in a balanced view on operational risk modelling and management. Substantial investment in scenario analysis has provided a forward looking view of risk, given the potential shortcomings of pure loss data driven approaches.

In particular, some areas where the ABA would recommend further consideration are as follows.

1. Risk sensitivity

While we acknowledge it is prudent to balance risk sensitivity with simplicity and comparability, we believe risk sensitivity can be improved without significantly diminishing the other objectives.

The recommendations below are consistent with the principles of the SA per section 6 of the Consultative Document and support the notion of capital results that are comparable between comparable banks. To understand the implications of the proposed risk sensitivity improvements below, we urge the Committee to perform analysis on such measures using the data collected through the 2014 Quantitative Impact Study (**QIS**).

a) Jurisdictional sensitivity

The SA could be more risk sensitive by calibrating the revised TSA against the OpCaR model utilising loss data for that jurisdiction and allowing the local regulator the discretion whether to apply the global coefficients or the jurisdictional coefficients. This would not reduce the comparability across jurisdictions as the approach would still be consistent and the difference between jurisdictions constrained to one factor (the coefficients). This approach would also better reflect differing risk profiles between jurisdictions, eliminate implications of EUR currency conversion, and could promote cross-jurisdictional support for the revised single approach.

b) Business indicator sensitivity

The SA is also insensitive to differences in risk profiles between interest-based and fee-based businesses. Weightings for different components within the Business Indicator (**BI**) could be introduced to improve risk sensitivity and with relatively little impact on simplicity. We recommend that further analysis be conducted to determine the appropriate weightings for the interest, services and financial components and the formula adjusted with recalibration performed accordingly.

2. Incentivising better risk management

The proposed revisions have no clear link between quality of operational risk management and capital requirement. As proposed, operational risk capital requirements under the SA, will only change with movements in income statement numbers and not with changes in the quality of operational risk management. Incentives could be considered that provide a direct and quantifiable link between the quality of operational risk management and operational risk regulatory capital including:

- Consideration of insurance and risk finance program deductions, which actively manage risk; and
- Policy measures on offsets and haircuts based on the performance of the operational risk management framework.

3. Revisions focused on large complex institutions

Revisions and observations noted in the consultation document appear focused on the weaknesses of the TSA in its application to large complex banking models, specifically:

- The document does not make reference to how the ASA may have worked well. An ASA was adopted for standardised banks in Australia which avoided the cyclicality associated with the proxies based on income and expenditure; and
- The indicative increase in capital under the SA is not commensurate to the loss experience observed in all jurisdictions and geographies.

4. Implementation Issues

While the SA addressed various weaknesses in the current TSA, we would like to draw the following implementation issues to your attention:

- The use of Euro denominated size buckets may introduce FX volatility in capital requirements for banks operating outside of Europe;
- The treatment of subsidiaries and banking models with partial use of TSA is unclear, specifically the applicability of proposed coefficients. The netting effect of P&L items within the "financial component" could also introduce diversification at the parent level; and
- The proposed EUR 10k threshold utilised in OpCaR is lower than the threshold utilised by many banks to collect losses.

5. Quantitative Analysis

The Consultative Document makes reference to quantitative analysis performed by the Committee. The ABA would welcome details of the analysis undertaken to be summarised and published to provide greater transparency into the modelling choices, assumptions and improve our understanding of key decisions and conclusions that have been made, specifically:

- The original Basel II business lines did not differ significantly in terms of their operational risk profiles;
- The preliminary calibration of a [five]-bucket structure, specifically the cluster analysis that was then carried out on the unexpected loss (UL) smoothing function with the aim of (i) aggregating in the same bucket banks with a similar risk profile; and (ii) identifying the most appropriate number of buckets for the sample;
- Loss data collection thresholds may be larger than the lower threshold of EUR 10,000 used to calibrate the model which leads to biased parameter estimates. For example, the ORX data collection threshold is EUR 20,000 which indicates that this issue would impact a number of banks globally;
- Sensitivity analysis to support the use of a conditional expected loss measure for calibration compared to a conditional median loss measure;
- Calibration of the regulatory coefficients and the increasing values from [10%] to [30%]; and
- Banks' operational risk capital levels under the current Basel framework were on average already under-calibrated in 2009, the year for which the data were collected under the Committee's 2010 QIS.

We thank you for taking our comments into consideration.

Yours sincerely,

Aidan O'Shaughnessy