

A response by the British Bankers' Association to the Basel Committee on Banking
Supervision's consultative document on a

Standardised Measurement Approach for operational risk¹

June 2016

The British Bankers' Association ("BBA") is the leading trade association for the UK banking sector with 200 member banks headquartered in over 50 countries with operations in 180 jurisdictions worldwide. Eighty per cent of global systemically important banks are members of the BBA. As the representative of the world's largest international banking cluster the BBA is the voice of UK banking.

All the major banks 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.

Our members manage more than £7 trillion in UK banking assets, employ nearly half a million individuals nationally, contribute over £60 billion to the UK economy each year and lend over £150 billion to UK businesses.

Summary of our comments

We recognise the challenges that the Committee faces in designing a regulatory framework that aims to balance risk sensitivity, simplicity and comparability and to measure operational risk.

We understand the Committee's conclusions that the current approach, which uses a percentage of Gross Income as the proxy-indicator of operational risk losses, is out-dated and in need of revision and that the outcome derived from the AMA models may give too much variability for regulators and the market to comprehend.

However, we also believe that the lack of consensus among regulators and their preferences for different approaches to the modelling of operational risk were also in part a cause of the problem.

We appreciate the effort that the Committee has made to study different options to resolve these shortcomings - many of which were set out in *Operational risk - Revisions to the simpler approaches* published by the Committee in October 2014².

¹ <http://www.bis.org/bcbs/publ/d355.pdf>

² <http://www.bis.org/publ/bcbs291.htm>

We agree that it is appropriate that the current framework should be revised and note the Committee's preferred approach for an operational risk measurement process which comprises two models:

- Business Indicator (BI) Component – representing a stylised systemic risk model, and;
- Loss Component (LC) – representing an idiosyncratic risk model - with the two models combined via the Internal Loss Multiplier (ILM).

We understand and support the Basel Committee's stated objective not to significantly increase overall capital requirements. However the analysis conducted by ORX (Operational Riskdata eXchange) to benchmark a sample of 54 ORX member banks during March 2016, indicates that if the proposed SMA was applied to banks' current risk profile it would result in higher operational risk capital requirements for nearly all banks of differing sizes throughout the world.³

Our conclusion is that the current proposals are over-conservative and over-sensitive to size of the BI and large losses thereby introducing disproportionately high and potentially volatile capital requirements.

We encourage the Committee to recalibrate the scaling of BI and LC to reduce the significant capital impact, in line with the Committee's own objective. This would also decrease volatility in both the methodology and the calibration so that a comparison of year-on-year capital is not unduly affected by shocks in either BI profit & loss or operational risk losses, and to be mindful of the need for reasonable transitional requirements.

In our response we set out suggestions which the Committee might wish to consider in order to address our concerns that in turn, we believe, could result in a simpler approach coupled with improved comparability whilst retaining risk sensitivity.

We think it is important that the Committee encourages the industry to continue to develop operational risk models for use in the ICAAP as a tool to assess Pillar 2, for stress-testing and in support of risk management. It is our hope that at some future date the Committee will be minded to reconsider its abolition of internal modelling approaches to operational risk for Pillar 1 purposes.

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³ <https://www.orx.org/Pages/ORXResearch.aspx>

Over-arching comments in addition to the answers to the Committee's questions

This section sets out our suggested refinements to the Committee's proposals that should be viewed as integral to our answers to the Committee's three questions.

Level of Calibration

- We think that the calibration of both the BI Component and the Loss Component is too conservative - particularly for the large banks - where the large Losses are weighted too heavily.
- We recommend calibration at a less conservative level, taking into account suggestions set out in this response, coupled with continued support for the use of supplementary buffers of capital, via Pillar 2 if necessary.

Systemic Risk

- We draw the Committee's attention to the fact that a component of systemic operational risk is already captured through the application of the G-SIFI, D-SIB and counter-cyclical capital adequacy buffers.
- We agree that some upward scaling in the percentages applied to increasing BI to capture systemic risk should be considered. However, we recommend that the Committee review and reduce the percentage applied to BI in excess of each threshold, in particular the BI percentages for the higher level BI buckets which are excessively punitive. This would have the benefit of minimising the lack of comparability of different business caused by the overall calculation at the holding company level being significantly greater than the sum of the constituent parts at subsidiary bank and/or branch level.

Appropriate balance between Pillar 1 and Pillar 2

- Banks are required by regulators to project their balance sheet, profit & loss statement (including operational losses) and risk-weighted assets forward in time in order to stress their prudential ratios. The US CCAR requires 9 quarters of projected data, while the UK PRA and ECB require 5 years and a minimum of 3 years respectively. In order to assess the prudential ratios after SMA is introduced banks will likely be expected to project forward the BI and losses.
- We recommend that the Committee encourages banks to continue to develop operational risk models for internal management purposes and to assist with ICAAP, stress testing and calibration of Pillar 2.

Adjustments to BI and Loss data

- We agree with the Committee's statement set out in section 6.1 paragraph 43 that *"Internal loss data are most relevant when clearly linked to a bank's current business activities, technological processes and risk management procedures"*. Accordingly we recommend that the Committee could make this requirement more explicit by

setting out guidance with respect to sold legal entities, discontinued businesses, and newly acquired businesses and legal entities.

- On page 11 paragraph e) we note that the Committee has proposed that *“Material ‘timing losses’ should be included in the SMA loss data set when they are due to operational risk events that span more than one financial accounting period and give rise to legal risk”*. We do not support this proposal as, in our view, it does not add value and will cause confusion.

Inclusion of Risk Mitigation

- We support the use of insurance to reduce risk and therefore we encourage the Committee to work with the banking and insurance sectors to reach an agreement on how insurance could be used to reduce the estimates of the losses and/or the overall determination of the capital requirement.

Thresholds and currency of calculation:

- The requirement to translate all € denominated BI Component values, range of BI and loss thresholds into the base currency or vice versa will result in the local currency capital requirement calculation being subject to changes in exchange rates. We recommend that regulators have discretion to set the local currency equivalent of the standardised € values.

Implementation

- We consider that in order to provide sufficient time for the incorporation of changes into national law, including the EU, that 1 January 2021 would be an appropriate globally consistent implementation date.

Answers to the Committee's three questions and additional comments

Q1. What are respondents' views on the revised structure and definition of the BI?

We recommend that the Committee considers the following refinements that would improve comparability and simplicity without reducing the risk sensitivity:

- Exclude operational risk losses from the calculation of the OOE component on the basis that a significant percentage of these will have already been accounted for by provisions in the P&L and these losses may introduce volatility into the capital calculation. Review the cap of 3.5% of NIM as a percentage of interest earning assets.
- Simplify the calculation for banks with high fee revenues and expenses. Simplify the calculation of the BI so it is revised to be equal to the average of the three years BI. This would keep the calculation of each year's BI as an independent function, be simpler to compute and comprehend, and would be consistent with the existing BIA and TSA that require the average of three years Gross Income (GI).
- To ensure consistency in the approaches of all banks to calculating BI the Committee should provide a manual detailing the mapping of the P&L and balance sheet items used in the BI computation under both US GAAP and IFRS. Our members would be pleased to support the Committee in this work.

Q2. What are respondents' views on the inclusion of loss data into the SMA? Are there any modifications that the Committee should consider that would improve the methodology?

We note the Committee's proposal to use ten years of historical data. We draw the Committee's attention to studies that suggest that there may not be a material difference if only 7 years of historical data were used. We would be supportive of using a shorter period of historical data provided that the calibration scaling of BI and losses does not introduce volatility, over-sensitivity and over-conservatism as compensation.

Calculation of the Loss Component

We draw the Committee's attention to the following matters: 1) There does not seem to be a link between the BI and ranges of losses and 2) The proposals do not allow banks with BI less than €1 billion to take into account the LC. These matters may lead to a lack of comparability and risk sensitivity.

To mitigate these shortcomings, while enhancing comparability and risk sensitivity, we suggest the concept of proportionality between BI and Loss thresholds should be introduced. This could be achieved by:

- Increasing the threshold for losses to be excluded from the LC from €10,000 to €20,000;
- Applying the respective scaling factor/multiple to the loss amounts only in excess of the threshold for each loss bucket;

- Recalibrating the scaling factors for each BI range so that they are less disproportionate;
- Setting the loss threshold ranges as varying percentage values of the mid-point of the BIC ranges;
- Increasing the number of buckets from three to four or five, provided the overall calibration of the LC is not excessive;
- Applying a lower multiple for the highest loss bucket to recognise the lower frequency of such extreme tail risk events;
- Excluding expected losses for which provisions exist already, from the calculation of the LC (or BI) to avoid double counting.

For the record we do not support a single scaling factor for all losses.

We recommend that bank subsidiaries and branches subject to a capital calculation within a group are treated on a consistent basis. Therefore irrespective of the size of their BI, banks should be permitted to include the LC and thus calculate the ILM subject to compliance with the *Committee's Principles for the sound management of operational risk (PSMOR)* published in 2011 and the general criteria on loss data identification, collection and treatment as set out in section 6.1 of the consultation.

This would allow bank subsidiaries and branches subject to a capital calculation within a group to be treated on a consistent basis. The Committee may wish to give regulators permission to set a BI threshold value below €1bn to exclude the use of the LC as well as to give direction on how banks should calculate the capital requirement when the BI moves above and below the threshold.

Q3. What are respondents' views on this example of an alternative method to enhance the stability of the SMA methodology? Are there other alternatives that the Committee should consider?

With regard to the overall calibration of the capital requirement, we think that the calibration of an ILM greater than 1.0 is over-stated and therefore should be re-calibrated.

Our preference is for a significantly less punitive re-calibration of the BIC and LC combined with the use of Pillar 2. We encourage the Committee to ensure that the combination of the BI and loss data produce stable and proportionate capital requirements. If this can be achieved, then we are of the opinion that the proposal set out in Annex 2 and or other formula proposals put forward may not be needed. If not then we support the introduction of a back-stop approach to cap extreme outcomes along the lines set out in Annex 2 with an appropriate value for m .

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