

June 3, 2016

Secretariat of the Basel Committee
on Banking Supervision (BCBS)
Bank for International Settlements
CH-4002 Basel, Switzerland

Dear Basel Committee members:

Re: CBA¹ Comments on the BCBS consultative document: *“Standardised Measurement Approach for operational risk”*.

We appreciate the opportunity to review the BCBS's consultative document, *“Standardised Measurement Approach for operational risk.”* While we understand the Basel Committee's goal for simplicity and comparability, we are concerned that the proposed Standardised Measurement Approach (SMA) may not provide sufficient incentives for banks to better understand the root causes of operational risk and to continuously enhance their operational risk management capabilities. Overall, we are concerned that the proposed SMA will decrease the comparability of institutions that have embedded a strong risk culture and control environment.

Our main concerns with the SMA are:

- *Accuracy as Measure of Risk:* We question the ability of the proposed SMA to accurately measure a bank's exposure to operational risk.
- *Calibration:* Despite the stated objective to not significantly increase overall capital requirements, initial assessments indicate that the calibration of the SMA formula will result in an increase in capital across the industry above the current measurement approaches.
- *Comparability:* Comparability may be jeopardized by potential interpretation differences.

We have provided our comments on the key issues below, and offer a more detailed response on the consultative document in the attached appendix.

¹ The Canadian Bankers Association works on behalf of 59 domestic banks, foreign bank subsidiaries and foreign bank branches operating in Canada and their 280,000 employees. The CBA advocates for effective public policies that contribute to a sound, successful banking system that benefits Canadians and Canada's economy. The Association also promotes financial literacy to help Canadians make informed financial decisions and works with banks and law enforcement to help protect customers against financial crime and promote fraud awareness. www.cba.ca.

ACCURACY AS MEASURE OF RISK

Business Indicator (BI)

We have not been provided with the supporting analysis to demonstrate that operational risk is aligned to measures of net income. Moreover, it is our understanding that statistically, there is weak correlation between income-related measures and operational risks. In addition, we believe that the proposed approach fails to recognize that banks operate under different business models (e.g. retail banking vs. investment banking).

The proposal assumes that banks of the same size (as measured by the value of its BI) have the same risk exposure, regardless of their business model or management practices. As such, two banks of similar size will attract the same BI, even if they have different business models and risk profiles.

We recommend that Basel business lines continue to be used to recognize differences in the inherent operational risk of various business activities, similar to the current Advanced Measurement Approach (AMA) and The Standardised Approach (TSA).

Loss Component (LC)

We believe that the SMA is too sensitive to historical loss and is not sensitive enough to recognize the current risk and control environment. We understand that the intended objective of using a 10-year observation period for Internal Loss Data is to leverage existing loss data maintained by banks, while the use of a simple average will reduce volatility in capital year over year; however, the current proposal places too much weight on historical losses without considering recent advances in operational risk management along with the state of the current business and control environments.

To demonstrate an additional concern, consider two banks of equal size, which therefore have similar capital requirements under the BI component. The first bank has a lower risk profile and is subject to high-frequency but low severity (expected) losses. The second bank has a higher risk profile and is subject to low-frequency but higher severity (unexpected) losses. With this example, it is possible that the first bank would be subject to higher capital levels than the second bank, which in turn should likely be subject to higher capital requirements given its higher risk profile (rather than historic loss profile). More importantly, there is a risk that the BCBS, through the issuance of the SMA, may be allocating capital to higher risk businesses only after material losses are experienced.

In our view, a loss that occurred 10 years ago, likely in a different business cycle and under different management, should not receive equal weighting to losses that have occurred in the current control environment. We recommend that the Basel Committee create a more effective incentive by considering a calculation that has greater weight assigned to periods that reflect the bank's current control infrastructure and culture.

CALIBRATION

BI Component Coefficients and Buckets

Since the proposed coefficients assume a linear relationship between capital and BI, and also for BI values within each bucket, we believe that they are excessively punitive for

large banks with a BI in excess of \$10B. We have identified three primary areas of concern with respect to the calibration of the BI component:

- 1. The BI buckets and corresponding coefficients:** As per the consultative document, *"the BI Component reflects the operational loss exposure of an average QIS bank of a given BI size."* However, as also noted, *"the BI Component was calibrated using QIS data collected by the Committee in the second half of 2015."* Given the short duration of QIS data available for calibration, it is possible the BI buckets and coefficients are not representative of true operational loss exposure across the industry through the cycle. We are requesting the Basel Committee commit to revisiting the BI calibration in the future when more data is available to support a re-calibration. We request a similar footnote to the notation from the June 2006 guidance on the BIA and TSA as follows:
"The Committee intends to reconsider the calibration of the Basic Indicator and Standardised Approaches when more risk-sensitive data are available to carry out this recalibration. Any such recalibration would not be intended to affect significantly the overall calibration of the operational risk component of the Pillar 1 capital charge."
- 2. Double-counting of BI and Loss Components:** The consultative document identifies that the Services Component of the BI must include *"Expenses related to establishing provisions/reserves for operational loss events."* These expenses are also included in the LC, since they are recognized operational loss events. We suggest the Basel Committee remove the expenses from the BI to eliminate the double-counting of these losses.
- 3. Impacts and treatment of foreign exchange translation:** The proposed BI buckets are based on Euros, and they would need to be regularly translated to ensure a level playing field across different currencies and to minimize the potential volatility of results. We are requesting clarification on how FX translation should be addressed for this approach.

Loss Component Multiplier

Regulatory capital is intended to protect banks from unexpected losses. The proposal attempts to address the unexpected nature of losses through the inclusion of multipliers for losses that are greater than €10 million and €100 million. However, depending on the bank's size, nature and complexity, the degree to which the proposal will capture the nature of unexpected losses will vary by bank.

For the loss component, there is the potential for extreme loss events above €100 million to have a 19x Average Total Annual Loss multiplier. We believe that the 19x multiplier is too severe, and further study on the potential impact to banks globally is required.

Our recommendation would be to adapt the following enhancements to the Loss Component:

- 1. Mutually exclusive ranges:** Instead of applying the multipliers to the full loss amount above each threshold, apply the multipliers on loss portions above the thresholds. This approach is consistent with the BI calibration methodology and will enhance the stability of the capital results by eliminating the potential cliff effects that result when large individual losses pass through the thresholds.

As an illustration, let us assume that a bank has an average total annual loss (ATAL) of €120 MM (one event of €120 MM for each of the 10 years):

- i. Under the current approach, an ATAL of €120 MM will be multiplied in the LC by 19 times:

ATAL of any size:	€120 MM x 7
ATAL above €10 MM:	€120 MM x 7
ATAL above €100 MM:	<u>€120 MM x 5</u>
	€120 MM x 19 = €2,280 MM

- ii. Under our proposed approach, the multiplier would be applied for the portion of the ATAL as follows:

ATAL of any size:	€120 MM x 7
ATAL ² above €10 MM:	€110 MM x 7 (€120 MM less €10 MM)
ATAL ² above €100 MM:	<u>€20 MM x 5 (€120 MM less €100 MM)</u>
	Sum = €1,710 million

2. **Weight current losses more than past losses:** We recommend applying a straight-line average, from the current simple average to weight current losses more than past losses, where:

Average Total Annual Loss = $\sum((\text{Total Annual Loss "Year n"} * (\text{"Year n"}/10)) / 5.5)$,
where "n" = 10 for the most recent year of operational losses, 9 = second most recent year of operational losses, etc.

3. **Relative thresholds:** We believe consideration should be given to normalizing the loss thresholds to the size of the institution. Rather than having €10 million and €100 million thresholds, this would imply setting relative thresholds based on ratios of the BI component to better account for size differences. A €100 million loss for a G-SIB is manageable, whereas for a small regional bank a loss of that magnitude may be catastrophic. This approach would normalize the definition for a tail loss across the industry.

COMPARABILITY

Factors

The comparability of SMA results may be impacted due to various data standards and their interpretation (e.g. varying accounting standards impact the BI components - i.e. US generally accepted accounting principles (GAAP) versus International Financial Reporting Standards (IFRS); treatment of FX rates can increase volatility; timing of discovery vs. recognition dates of losses), which may reduce the comparability of the SMA results. Please see the attached detailed comments for more discussion on these factors.

Role of Supervisory Review (Pillar II)

While the objective of the SMA is to promote comparability of risk-based capital measures and reduce model complexity, the proposal is entirely focused on regulatory capital (Pillar I) rules. Without concurrently considering Pillar II, national supervisors may

² Only including the portion of individual loss events above the thresholds

have the authority to require banks to continue to adopt AMA requirements while other jurisdictions will not leading to a further widening range of practices. The divergence of practices would not meet the objective of promoting comparability of the operational risk capital held by banks, and may create an uneven playing field.

CONCLUSION

In compliance with Basel II and domestic regulatory requirements, most Canadian domestic systemically important banks (D-SIBs) have invested in their operational risk management capabilities. The proposed SMA may de-couple operational risk management practices with its measurement.

We thank you for taking our comments into consideration and look forward to future discussions on these issues.

Sincerely,

A handwritten signature in black ink, appearing to read "Darren Hamel". The signature is fluid and cursive, with a long horizontal stroke at the end.

Enclosure: CBA detailed comments

cc: Brad Shinn, Managing Director, Capital Banking, OSFI Regulation Sector
Richard Gresser, Senior Director, Capital Banking, OSFI Regulation Sector
Noeleen Riordan, Senior Analyst, Capital Banking, OSFI Regulation Sector

CBA comments on Basel Committee consultative document: *Standardised Measurement Approach (SMA) for operational risk*

CBA Members' Comments and Requests for Clarification	
1. INTRODUCTION (Page 1)	
- What type of analysis was done by the committee to formulate the conclusion that, "...a simple standardised measure of operational risk and a bank-specific loss data provides a sufficiently risk sensitive measure of operational risk"? Although the SMA is more risk sensitive compared to 2014 RSA, it is still mainly driven by BI. - We believe that the proposed approach decouples operational risk measurement from operational risk management. We are concerned that the industry will scale back investment in the area of operational risk modeling/measurement, given the prescribed calculations under SMA. There is no capital incentive to continue investing in this area and manage your operational risk profile. Instead banks will focus on reducing operational losses over time; while beneficial, loss management is not the same as operational risk management.	
2. WITHDRAWAL OF INTERNAL MODELLING FOR OPERATIONAL RISK REGULATORY CAPITAL FROM THE BASEL FRAMEWORK (Pages 1 – 2)	
- Regulatory capital calculated based on historic loss experience may not be sufficient for absorbing future losses due to changes and increases in operational risk profiles. - The AMA framework becomes more mature and stable as banks collect additional internal loss data (ILD) and gain expertise on how to better integrate external data/scenarios analysis. Did the committee consider the alternative of improving the AMA framework and provide more guidance on, for example, acceptable practices or lowering the estimation target (i.e. Value at Risk (VaR) percentile)? - We believe that the two primary issues with AMA (i.e. model stability and comparability) can be addressed by: (1) calculating the capital at a lower percentile (e.g. 1 in 20 years instead of 1,000 years) and scale-up via a multiplier; and (2) standardizing the AMA model across the industry.	

CBA Members' Comments and Requests for Clarification**3. NEXT STEPS** *(Page 2)*

- Without additional information on why the committee decided that issues with the AMA could only be addressed by removing the AMA, and documentation describing how the SMA was developed, it is difficult to provide comprehensive feedback on the proposed change.
- It would be helpful if Basel Committee would share their analysis done on calibration of the SMA model as part of next steps.

4. THE STANDARDISED MEASUREMENT APPROACH (SMA) FOR OPERTIONAL RISK *(Pages 3 - 8)*

- The strengths of SMA are in consistency and simplicity. It is more risk sensitive than both The Standardised Approach (TSA) and The proposed Revised Standardised Approach (RSA). However, it also has many weaknesses, as follows:
 1. It is backward looking. This is especially the case if a bank enters into a new business. Banks cannot adjust their SMA capital requirements to reflect their forward-looking views through scenario analysis or business environment and internal control factors.
 2. The capital measurement is conservative for banks with strong risk controls. The SMA is risk sensitive as operational losses are increased. However, at levels close to the lowest bound within the Internal Loss Multiplier, the SMA capital requirement is too conservative for large banks with very low operational losses.
 3. The 10-year loss limit proposed in the Internal Loss Multiplier will result in a cliff effect for large loss that reaches the 11-year mark.

4.1 The Business Indicator (BI) *(pages 3 - 5)*

- There is a lack of transparency to support that operational risk is aligned to measures of net income.
- The proposed approach does not sufficiently recognize a bank's business model (i.e. retail banking vs investment banking). It assumes that banks of the same size (as measured by the value of its BI) have the same risk exposure, regardless of their business model or management practices. With AMA and TSA, the use of Basel business lines recognizes the differences in the inherent operational risk of various business activities.

CBA Members' Comments and Requests for Clarification**Q1. What are respondents' views on the revised structure and definition of the BI?**

- There are no theoretical and empirical justifications provided for both the revised structure and BI component, especially on coefficient, bucketing and the use of financial results (especially net interest income) as proxy for operational risk. The revised structure is similar to the Revised Standardised Approach in being backward-looking. This means that the future is like the past and that all operational risk management processes are also assumed to be stationary. There is less incentive for banks to improve operational risk management with the averaging of financial and loss over time. Conceptually, the different averaging of financial and loss over time periods is statistically incongruent.
- The definition of BI has improved over the BI definition in the proposal dated October 2014 by addressing the sale of third-party products, the treatment of dividend income, business models with a high net interest margin and high fee components, as well as business models based on credit finance, financial leasing, and operating leasing.
- BI component is a main driver of the operational risk capital. The larger the bank, the higher the BI, and the larger the operational risk capital required. The BI is mainly driven by Interest, Lease and Dividend Component (ILDC) and net fee income. This is because the BI is a function of ILDC, Service Component, and Financial Component, whereby 85% of the ILDC is made up of net interest income and ILDC is part of Service Component. Two banks with similar size and BI and different risk profiles will have similar capital requirements. Statistically, there is weak correlation between income and operational losses.
- We believe comparability amongst banks will become more difficult unless we harmonize the definition of the BI components similar to the work performed to harmonize gross income:
 - Provide a distinction between "*Administrative expenses*" vs. expenses from "*Ordinary banking operations*".
 - Guidance on acquisitions and divestitures need to be stated for inclusion/exclusion for the treatment of BI components and losses (e.g. TSA incorporates three years of gross income data for any acquisition).
 - Dividend income from associates and joint ventures should be excluded from the BI as the investment is a deduction from capital (subject to a threshold).

CBA Members' Comments and Requests for Clarification**4.2 The BI Component** (pages 5 - 6)

- The proposed BI buckets are based on Euros, and they would need to be regularly translated to ensure a level playing field across different currencies.
- We are concerned that the buckets are too broad (specifically #4) and the coefficients are too high, resulting in much higher capital when compared with the TSA.
- The proposed coefficients assume a linear relationship between capital and BI and also for BI values within each bracket, and are especially punitive to the large banks with a BI in excess of \$10B.
- Will the annual value of BI for years 1-3 be based on rolling quarters? Please clarify.

4.3 The Internal Loss Multiplier and Loss Component (pages 6 - 7)

- The proposed approach is loss sensitive rather than risk sensitive. The introduction of the Internal Loss Multiplier does not necessarily tie to a bank's current risk exposure since the focus is on historical losses. Since the calculation is based on losses over a 10-year period, a bank will have to wait many years to experience any capital benefit from any improvements to its control environment, which should result in lower losses. On the other hand, it will provide a reprieve for banks that cannot ignore any of their large losses in their historical data under the AMA approach.
- The Loss Component appears sensitive to internal losses due to the built-in multipliers (i.e. losses about 100MM are multiplied 19 times, losses above 10MM are multiplied 14 times, and losses less than 10MM are multiplied 7 times). However, the lower bound within the Internal Loss Multiplier is high for banks with very effective risk controls and low operational losses.
- We request clarification on some specifics:
 - How will the loss component be re-calibrated for the cliff effect as large losses drop outside of the observation period after 10 years?
 - How will the committee recommend regulators monitor any proposed "exceptions/outliers"?
- We believe that losses (exceeding the threshold for loss data collection) from the last three years will be over-stated in the model, since they are considered first in the 3-year average of BI and then again in the 10-year average of LC. Was the purpose of this design to allocate more

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eight to losses in the last three years?

- It is unclear if losses experienced by global banks, relative to Canadian banks, are appropriately reflected in the internal loss multiplier.

4.4 The SMA capital requirement (pages 7 - 8)

- There is no conceptual and theoretical justification provided on how the bucketing and coefficients have been designed.
- There is no evidence provided to justify that the SMA capital will not over/under capitalize the bank.
- There is no guidance given on the frequency of updates to BI buckets and various coefficients. We request clarification on how the FX rates will be updated since the formula was based on a limited dataset to reflect an “average” bank performance. As the dataset changes and the “average” changes, how will it be captured in the formula? Also, it is unclear how a threshold for data identification will be applied consistently across geographies and institutions. One threshold should be agreed upon and should also include a standard methodology for FX conversion.
- The approach does not consider risk mitigation through insurance.

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?

- If a bank has an unusually large operational loss, it will take time for the SMA to catch up with the loss since it is an averaging process. Likewise, using the 10 years of loss data will have a cliff effect as soon as large losses fall outside of the 10-year window.
- The lower bound applied to the Internal Loss Multiplier is unfavourable to banks with good operational risk controls and low losses. Operational risk capital will increase at a decreasing rate with increasing loss component. The main drivers are (1) high lower bound for the internal loss multiplier, and (2) BI component which is sensitive to the financial data.
- The SMA is a standalone capital measurement approach with no tools and incentives to help banks better understand the root causes of operational risk and manage their operational risk accordingly.
- The SMA will not provide comparable or necessarily stable results given the variability of the loss profile across geographies and the “cliff

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effect”. ▪ We also recommend that the Basel Committee should consider calibrating the BI component and Loss Component using same time horizon.	
5. APPLICATION OF THE SMA WITHIN A GROUP (Page 8)	
▪ No comments.	
6. MINIMUM STANDARDS FOR THE USE OF LOSS DATA UNDER THE SMA (Pages 8 - 11)	
▪ Of the four broad categories of inputs used in AMA modeling, only the internal losses are used in the SMA Capital measurement. This means that any improvements made to risk controls or changes made to the bank's business models will not be reflected in the operational risk capital charges.	
6.1 General criteria on loss data identification, collection and treatment (pages 9 - 10)	
▪ The proposal states that a bank must develop specific criteria for assigning loss data arising from an event in a centralized function (e.g. an information technology department) and from common or related events over time (“grouped losses”). While this requirement has historically been deemed appropriate, there are circumstances where the cost and effort to group losses from a common event significantly outweigh the benefits from doing so (i.e. practical limitations and challenges of definitively assigning external cyber security breaches to credit card fraud activity). The proposal should address the need to appropriately balance the costs of grouping loss events with the benefits so as to ensure consistent expectations by various supervisors. ▪ The 10-year cut-off creates a cliff effect with capital numbers falling dramatically if internal large losses reach the 11-year mark. It will provide a reprieve for banks that cannot ignore any of their large losses in their historical data under the AMA approach. ▪ There is a risk of cross-risk arbitrage with events such as collateral failure booked in credit risk categories to avoid their inclusion in the operational risk capital charge. ▪ The importance placed on good documented procedures and processes as well as mapping into the relevant Level 1 supervisory categories	

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will not have any impact on the capital charge although they are important from a risk management point of view.

6.2 Specific criteria on loss data identification, collection and treatment (pages 10 - 11)

- Paragraph 45 is unclear. Is a cash-flow (i.e. income statement profit and loss (P&L) methodology) meant as the standard or an event-flow (i.e. all amounts are attributed back to the date recognized of the first loss impact).
- Grouped Losses – a standard methodology/practice should be recommended for grouping losses. This practice can have wide variations amongst institutions and can have significant SMA capital implications based on the threshold buckets (i.e. a €10 million grouped loss could have a material capital impact while, 10x €1 million will have a lower capital impact).
- The current document states that banks must not use losses net of insurance recoveries as an input for the SMA loss data set, which implies that losses net of recoveries, excluding insurance recoveries can be used when determining the average total loss over the prescribed period. This appears to contradict the reference to gross loss computation of the SMA loss data set. Please clarify.
- Pending losses - the proposed document states that gross loss computation of the SMA loss data set should include "*Losses stemming from operational risk events with a definitive financial impact, which are temporarily booked in transitory and/or suspense accounts and are not yet reflected in the P&L*". This is a departure from current practice since these events will not be captured in an institution's loss data base until the loss actually materialized in the P&L. To the extent that most institutions have strict rules around the use of transitory/suspense account and usually requires these accounts to be cleared within 30 days, it may be premature to include losses that have not yet booked to the P&L in loss computation.
- Reference date – The occurrence date is more appropriate than the Date of Discovery since it reflects the control environment or risk exposure at the time the event occurred.
- The proposed document states that for "*legal loss events, the date of accounting is the date when a legal reserve is established for the probable estimated loss in the P&L*". In practice, the date of accounting could be earlier than the date when a legal reserve is established since an institution normally starts incurring external legal costs as soon as the Notice of Claim is received. Which date should be used: the date when a loss is first recognized in the P&L for the event; or the date of the first provision? Please clarify.

CBA Members' Comments and Requests for Clarification**ANNEX 1 – BUSINESS INDICATOR DEFINITIONS** (Pages 12 - 13)

- The inclusion of dividend income from associates and joint ventures is problematic as the investment is a deduction from capital (subject to a threshold). Having said that, we have included the equity-accounted increase in value recorded in the income statement rather than the dividend in our analysis.
- The proposed BI components do not align to current financial reporting or management reporting categories. An overhaul of the current reporting categories will be required to implement the proposed approach correctly, otherwise an institution may over/under report it's BI for capital calculation purposes.
- Inconsistencies in financial accounting practices across jurisdictions could also result in inconsistent application of the revised BI component under SMA.
- Expenses related to establishing provisions/reserves for operational loss events are double counted as they are included in BI as well as Loss Component. Please clarify.

ANNEX 2 – EXAMPLES OF AN ALTERNATIVE METHOD TO HELP ENSURE THE STABILITY OF THE SMA METHODOLOGY

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?

- Depending on the calibration of the “m” coefficient, for a more stable capital treatment, this method should be considered by regulators as an alternative to the proposed SMA. More study is requested, perhaps in combination with the inclusion of qualitative risk management assessment (e.g. current risk and control environment).
- The alternative method suffers similar concerns as in the proposed SMA methodology, as follows:
- The alternative method has not mitigated the conservatism in the proposed internal loss multiplier. If there is no loss component, the capital requirement will be 50% of the BI component. It is also a decreasing function of “m”, which means calibration becomes critical.
 - The BI is a sophisticated way of using the gross income concept.

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- There are no details on the loss component. If the internal loss is based on a simple arithmetic average of the last 10 years of internal losses recorded by banks, it will suffer similar problems with the Internal Loss Multiplier; that is, it will create a cliff effect for large losses hit the 11-year mark.
- The use of banks' own loss data may be relevant but, similar to the challenges identified in the AMA approach, it is backward looking.
- Possibility of cross-risk arbitrage. If there is an operational risk loss related to credit, it can be booked as part of credit losses, thus avoiding its inclusion in the op risk capital charge.