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

Dear Basel Committee members:

Re: CBA[1] Comments on the consultative document:
"*Operational risk – Revisions to the simpler approaches*"

We appreciate the opportunity to review the Basel Committee's consultative document, *"Operational risk - Revisions to the simpler approaches".* We understand that the Basel Committee is considering whether or not to replace the current non-model-based approaches with the proposed Business Indicator (BI) approach. We strongly recommend that the Basel Committee reconsider the proposed approach.

We have the following areas of concern with the proposed approach. It:

- Removes the incentive to improve operational risk management practices;
- Does not reflect the level of operational risk exposure; and
- Is complex to implement.

We do not believe the proposed approach is enough of an improvement over the current Standardized Approach (TSA) methodology to justify the additional implementation effort required. We are also concerned that the proposed approach is much more complex to implement than it might at first appear, and will burden existing resources with little benefit in terms of improving risk measurement and management capabilities and practices. Not only will it divert attention away from further enhancing operational risk management practices, but it will also preclude the development of risk measurement methodologies that could be used to address weaknesses in the existing approaches. We are also concerned that the proposed approach could eliminate incentives for large internationally active banks to use the risk-based Advanced Measurement Approach (AMA), and that this will interfere with the development and use of more sophisticated and rigorous operational risk management practices.

[1] The Canadian Bankers Association works on behalf of 60 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.

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

Removes Incentive to Improve Operational Risk Management Practices

Strengthening the link between risk measurement and risk management is an imperative. In the current simpler approaches, there are minimum standards for risk management practices that an institution is required to meet as part of accreditation requirement. With increasing levels of complexity, banks need to more carefully evaluate their capital requirements and are expected to have sophisticated and robust risk management practices. The AMA further incorporates the loss experience of the institution in determining the level of capital requirement, which provides a strong level of incentive for financial institutions to improve risk management practices. While capital requirements are a means to protect against exposure, sound risk management practices are fundamentally the key to ensuring continued safety and soundness of financial institutions. As such, it is recommended that the linkage to incentives for sound risk management practices be incorporated in any proposed approaches.

More importantly, since the AMA provides the best incentives for improvement of sound operational risk practices, this approach should be preserved, and its ability to incent good risk management practices should not be impeded by a restrictive capital floor based on simpler approaches.

The large Canadian banks, and other systemically important banks around the world, have spent over 10 years developing their AMA models. There has been considerable knowledge accumulated through the use of such methodologies, and the AMA is becoming a more refined predictor of operational risk (e.g. scenarios provide more of a leading indicator around risk levels). As the AMA tools (both quantitative and qualitative) are refined and with increased disclosure of approved model results, we expect that there will be a narrowing of best practices and increased consistency and comparability between the AMA results from complex institutions. As such, we do not believe that standardized approaches are the only way to achieve comparability.

We also believe it would be a significant loss to the risk management discipline if international incentives were not maintained for these useful and informative AMA tools. Complex institutions require more than “one-size-fits-all” simplified models, which do not effectively capture the full spectrum of risks to the organization and the financial system.

Does not reflect the level of operational risk exposure

One important goal for the capital regime is ensuring comparability of capital for institutions with similar risk exposure or profile. The proposed approach does not appear to meet this principle on two levels: (a) inadequate representation of risk drivers, and (b) issues with calibration.

a. Risk Drivers

   The industry collectively has made considerable progress in reviewing risk drivers as part of the work effort to implement the AMA. General observations from that work suggest the size of an institution is not a reliable predictor of exposure.

In particular, it is observed that different business lines and different jurisdictions are significant risk drivers. Relying on size of operations as the sole determinant of operational risk does not meet the stated principle of “enhanced risk sensitivity”, nor does it calibrate according to the operational risk profile for different business models. As an example, take two banks with different business models, one a traditional retail bank (with stable earnings mainly from the interest components) and compare it to a bank that predominantly does trading activities (earnings derived mainly from volatile financial components). These two banks can have the same level of capital if the total earnings are the same, whereas clearly the riskiness of the two is not comparable.

The proposed approach is regressive compared to the current TSA where both size and business lines are considered in determining capital. We believe that the proposal should seek to address the impact of income volatility from higher risk businesses and, at a minimum, should continue to use business lines to differentiate the inherent operational risk profiles of the underlying business activities.

b. Calibration

One of the weaknesses of the current simpler approaches is that they have been calibrated based on poor quality data (i.e. without extensive loss databases and with only the model experience in existence in the early 2000’s). Rather than spending resources to develop another proxy (i.e. the BI), we think that there is merit in exploring ways to improve the existing TSA and current historical data, and a revised TSA should be factored into the next iteration of a simpler approach.

Indeed, we consider data to be one of the key flaws of the existing TSA and Basic Indicator Approach (BIA) since they were calibrated using incomplete loss data predating 2006. As such, we believe the current TSA could easily be improved by calibrating the betas based on the most complete and recent loss data. Furthermore, the TSA methodology would need to be enhanced to take into account higher risk businesses that experience greater levels of volatility in gross income, particularly decreases in gross income. To ensure ongoing relevancy, we would also recommend that periodic review and calibration be scheduled for the simpler approaches. These remedies are much less resource intensive than the development of a brand new and untested standardized approach. Enhancements to the TSA can result in a methodology that is more responsive to different business models and the complexity of a financial institution rather than the proposed approach, which is based solely on size.

Is Complex to Implement

We are not convinced that implementing the proposed simpler approach is indeed “simple”. It would require considerable work effort to retrofit existing operational risk data sources into a new methodology. Furthermore, the complexity of the BI approach will create challenges in the ability to verify the completeness and accuracy of its calculations.

We note the following complexity in the implementation of the proposed approach:

- The proposed components of the BI do not align with financial accounting practices. As such, significant work will be required to:

    - ensure consistent interpretation between jurisdictions and financial institutions;
    - implement the changes; and
    - provide ongoing supervisory monitoring for compliance.

- The proposed BI buckets are based on Euros, and they would need to be continually adjusted to ensure a level playing field across different currencies as exchange rates change.

Given our past experience in mapping gross income for TSA, which was a significant work project, this will serve to divert scarce resources from efforts to enhance the measurement and management of operational risk through ongoing AMA development and maturation of the sound principles for the management of operational risk.

Timing

We would appreciate clarification on the expected timeframe for implementing this approach. This is particularly relevant due to the expected material increase in capital required under the proposed approach.

Conclusion

Overall, we believe the proposed changes do not improve risk sensitivity or enhance the link between risk measurement and risk management, and they divert resources from current efforts in these areas. Furthermore, given the inherent flaws of the proposed approach, we are concerned with the intent to use it as a floor or to benchmark AMA. As such, we would prefer to enhance the existing TSA, since it better recognizes the underlying riskiness of the various business lines rather than only emphasizing the size of a financial institution. Not only is this approach more closely aligned with the way a bank manages risk, but after simple improvements as mentioned above, we believe it would be more effective in preserving the incentives and resources to enhance more sophisticated risk management capabilities and promote the corresponding evolution to the AMA approach for complex institutions.

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

Sincerely,

for: Marion Wrobel

Enclosure: CBA detailed comments

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

CBA detailed comments on Basel Committee consultative document: *Operational Risk – Revisions to the simpler approaches*

CBA Members' Comments and Requests for Clarification

EXECUTIVE SUMMARY *(Pages 1 - 4)*

REVISIONS TO THE OPERATIONAL RISK STANDARDISED APPROACHES *(Pages 5 – 16)*

I Background *(pages 5 - 6)*

Q1. Are there any other weaknesses in the existing set of simple approaches that should be addressed by the Committee?

- The existing approaches' use of gross income and risk coefficients were originally calibrated in the early 2000's when little data or model experience existed. Given the faulty data used upon initial calibration of the Basic Indicator Approach (BIA) and the Standardized Approach (TSA), we believe the alphas and betas should be recalibrated to reflect the improved and longer time series data that is available today. Furthermore, these capital coefficients should be assessed on a regular basis to reflect changed circumstances.
- The continued use of Basel defined business lines is important in order to differentiate the inherent operational risk related to the various business activities. Internal loss experience relative to gross income continues to demonstrate differing rates of loss amongst the Basel defined business lines.
- We note that a measure based on simple averages of gross income can overstate the risk for traditional retail businesses vs. capital market business lines. We believe that the calculation of the proxy should be designed to account for volatile income streams in order not to penalize lower risk businesses that generate consistent and stable earnings over time. .
- The Business Indicator was calibrated using Basel's Operational risk Capital-at-Risk (OpCaR) model. The OpCaR calculation was done at a bank group level and not at a specific risk class, which may bias the results. That is, modelling operational risk at a bank total level mixes high frequency/low severity events with low frequency/high severity events and as such may result in the selection of fatter tailed distributions as compared to modelling these different units of measure separately. Furthermore, the historical data used for the exercise was outdated (i.e. 2008).
- We believe that the new approach should ensure capital neutrality across all jurisdictions and banks, regardless of the native currency (i.e.

CBA Members' Comments and Requests for Clarification
how will the model's coefficients be translated for non-Euro currencies?).
II. Principles of the revised Standardised Approach (SA) *(pages 6 -7)*
III. Elements of the revised SA *(page 7)*
▪ The proposed Business Indicator (BI) components do not align to current financial reporting and disclosures (e.g. published financial statements) 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. In addition, there would be challenges with independent reconciliation of the BI. ▪ Inconsistencies in financial accounting practices across jurisdictions could also result in inconsistent application of the revised SA approach. ▪ Given our past experience in mapping gross income for The Standardized Approach (TSA), which was a huge work effort, we believe that it would be less disruptive and more practical to revisit the design of the BI components to reflect current reporting categories.
Objectives of the review *(page 7)*
Q2. Does a single standardised approach strike an appropriate balance across the Committee's objectives of simplicity, comparability and risk sensitivity? ▪ A single approach is simpler but the trade-off is risk sensitivity. Notwithstanding that the simpler approach was calibrated to an operational loss driven model, the simpler approach is not fully risk sensitive and AMA is a better predictor of operational risk (e.g. scenarios provide more of a leading indicator around risk levels). Therefore, implementation of a revised simpler approach should also be accompanied with an incentive to move to an AMA method. However, given our concerns over the risk sensitivity of the proposed methodology, we caution its use as a benchmark or floor in which to compare the AMA. ▪ 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. ▪ We believe that the key will be the home supervisor's timeline to comply. How will "partial usage" be applied to AMA banks? Are coefficients

CBA Members' Comments and Requests for Clarification	
calculated at the entity level? How will the simpler approaches be used as a floor for AMA banks (e.g. AMA capital results must be within a certain percentage of the simpler floor calculation)?	
Refinement of the proxy indicator for operational risk exposure *(pages 7 - 11)*	
▪ 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. The use of Basel business lines recognizes the differences in the inherent operational risk of various business activities.	
Q3. Are there any further improvements to the BI that should be considered by the Committee? ▪ We believe that there should be further analysis on the emphasis on size as a key determinant of risk exposure. One question is to what extent the frequency and size of losses related solely to the size of the bank rather than complexity or other aspects such as those identified in the Sound Principles? ▪ The Basel Committee should consider designing a methodology to account for those banks or businesses that generate volatile results, which lead to a lower average over time.	
Improving calibration of the regulatory coefficients *(pages 11 - 14)*	
▪ As previously noted, we are concerned with the elimination of the business lines with associated capital coefficients since $1 of BI from two very different business activities should be treated the same. ▪ Preliminary estimates by one bank indicate that the new methodology will increase capital by roughly 70%. We are concerned that the coefficients are too high, especially if the standardized approach becomes a de facto floor for AMA. ▪ The BI brackets will have to be adjusted for each currency if the proposed coefficients are implemented to ensure a level playing field for operational risk capital requirements across all jurisdictions. For example, a bank in a jurisdiction where the native currency is trading below the Euro will reach the higher "tax" brackets sooner than a bank that has the equivalent BI in Euros; the opposite holds true for jurisdictions where the native currency is trading above the Euro. Additionally, the "tax" brackets will have to be adjusted quarterly/annually, depending	

CBA Members' Comments and Requests for Clarification
on the movement in the foreign exchange, to ensure capital neutrality across the different jurisdictions. ▪ The proposed coefficients still assumes a linear relationship between capital and BI and also for BI values within each bracket, and is especially punitive to banks with a BI in excess of $30B.
Q4. What additional work should the Committee perform to assess the appropriateness of operational risk capital levels? ▪ Calibrate using the data for different lines of business and determine the effect of business type on capital levels. ▪ We would like to suggest the Basel Committee obtain more evidence of the correlation of the BI and the coefficients to actual loss experience. ▪ Has the Basel Committee looked at the full spectrum of different sized banks in its analysis, as this document refers to large banks. Has the analysis covered sufficiently the small and mid-tier as found in the Canadian context?
Q5. Are there any other considerations that should be taken into account when establishing the size-based buckets and coefficients? How many BI buckets would be practical for implementation while adequately capturing differences in operational risk profiles? ▪ As discussed in the consultative paper, the number of buckets was determined based on cluster analysis. Although five was determined to be optimal, through the recent QIS loss data collection exercise it may be helpful to provide two more sets (e.g. one with 3 and another with 7) and allow banks to calculate using each set to see what the effect is in order to validate and finalize the proposals. ▪ We believe that the number of buckets would not cause additional complexity for implementation, but the distribution of the ranges in the 5 buckets appears to give too much weight to bucket 4 (the range of 3750 – 37500). ▪ The key with the buckets is clearly outlining the principle so each bank can relate its operations to the bucket.
Q6. Are there any other considerations that should be taken into account when replacing business lines with size-based buckets? ▪ In reviewing the root causes of operational risk, did the WGOR take into consideration the severity of the losses, such as US litigation losses, which we believe should not be attributed to every jurisdiction? ▪ We believe that the proposal should not restrict the proxy to size and continue to use business lines to differentiate their inherent operational risk exposures.

CBA Members' Comments and Requests for Clarification	
▪ We also believe that the proposal would need to be harmonized with accounting definitions and regulatory reporting requirements as set out in generally accepted accounting practices. ▪ We suggest a review to gather more evidence that the product lines are not sensitive to operational risk, and that BI size alone is a fair common measurement to all banks.	
Q7. Could there be any implementation challenges in the proposed layered approach? ▪ For implementation challenges, as with all regulatory requirements, the key is sufficient time to make the changes.	
Calculation of minimum capital requirements *(page 14)*	
▪ The tiers are expressed in Euros. How will the tiers be applied across jurisdictions with different local currencies? ▪ When a portion of a bank is under AMA and a portion is under SA, how should the SA portion be calculated? ▪ Will the annual value of BI for years 1-3 based on rolling quarters? ▪ How will the proposed changes to the SA approach impact the implementation of the Partial Usage (of AMA), The TSA approach allows for easy monitoring for ongoing compliance to the Partial Use rules, which will be more problematic under the new SA.	
Dealing with banks facing specific situations *(pages 15 - 16)*	
Q8. Do the issues of high interest margin and highly fee specialised businesses in some jurisdictions need special attention by the Committee? What could be other approaches to addressing these issues? ▪ Size may not be the only driver and/or it may have a much lower impact and so other factors such as business type should also be reviewed. ▪ Yes, as this is due to the issue of using the same coefficient for the three components of the BI (Interest, Services, Financial), while not differentiating different business lines.	

CBA Members' Comments and Requests for Clarification
Risk management expectations under the revised SA *(page 16)*
Q9. What would be the most effective approach to promoting rigorous operational risk management at banks, particularly large banks? ▪ We believe that large banks should use the AMA models, and thus the simpler approaches should be tailored to incent banks to use the more risk-based AMA practices (e.g. scenarios analysis, Business Environment and Internal Control Factors (BEICF)). If a floor is established based on the simplified approach, how will it be calibrated to incent banks to move to the AMA (i.e. if the floor is 100% the standardized model capital requirements, it could be well above the AMA results). ▪ Given the inherent flaws in the proposed approach, we are concerned with its use as a floor or method in which to benchmark AMA. ▪ Banks are motivated to manage operational risk, but providing more incentives such as opportunities to reduce capital assists in further investments in this area. For example, improvements in the control environment can be evident in reduced losses and so providing guidance around a process for large events to "fall away" or reduce the impact of capital would be beneficial. ▪ One important approach is to ensure that the calculation of regulatory capital itself encourages such action.
ANNEX 1 – Definition of the Business Indicator *(Pages 17 - 19)*
▪ Services component, fee and commission expenses: Given the list of expenses that are not included, can this line be adequately defined to allow equal application across jurisdictions? ▪ Services component, Other operating expenses: Given the list of expenses that are not included, can this line be adequately defined to allow equal application across jurisdictions? ▪ Although the guidance tries to be explicit, it still leaves some room for interpretation as to what items should be included in the BI calculation (e.g. the distinction between "Administrative expenses" vs. expenses from "Ordinary banking operations").
ANNEX 2 – The OpCaR methodology *(Pages 20 - 29)*
▪ It is noted in paragraph 7, the exclusions of scenario analysis and business environment and internal control factors may cause, in some

CBA Members' Comments and Requests for Clarification	
cases, an underestimation of the Operational risk Capital-at Risk (OpCaR) model figures mainly because scenario analysis data are sometimes included in banks' AMA models to estimate infrequent and large tail events. This potential underestimation was addressed by a more conservative choice of the class of severity distributions in the OpCaR calculator. However, we believe that it could also be the case that by excluding those same factors, OpCaR figures are overestimated. In addition, operational risk mitigants are not taken into account.	
ANNEX 3 – Investigation of 20 potential indicators of operational risk exposure *(Pages 30 - 44)*	
ANNEX 4 – Loss data collection and risk management guidance for large internationally active banks under the revised SA for operational risk *(Pages 45 - 46)*	
▪ A key element will be the proper definition of "*near misses*" (point 5) and "*losses are rapidly recovered*" (point 2)" for consistency and comparability across banks.	