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[5 January 2015]

Dear Sir/Madam,

Re: BCBS Consultation Document on Operational risk –Revisions to the simpler approaches

China Banking Association presents its compliments on the opportunity of communicating to the Committee the China's banks' views and comments on BCBS Consultation Document on Operational risk –Revisions to the simpler approaches. China Banking Association (CBA) is a nationwide non-profit self-discipline organization of China's banking sector. CBA serves for the common interest of its members through the functions of self-discipline, rights protection, coordination and service so as to safeguard lawful rights and maintain market order of the banking sector, and promote the healthy and sustainable development of the industry. By July 2014, CBA has 373 members and 4 observers.

In general, CBA greatly appreciates the great endeavor you have made in enhancing operational risk approaches as well as the opportunities you provided to solicit the industry's comments on it. On this important topic, we therefore have solicited member banks' main comments as below for your reference, which we hope could be helpful.

Yours faithfully,

A handwritten signature in black ink, appearing to read '杨再平' (Yang Zaiping), written in a cursive style.

Yang Zaiping

Executive Vice President

China Banking Association

Specific Comments

I. The applicability of the revised Standardized Approach to China Banking Industry is open to discussion.

1. The consultative document (Henceforth as CD) on the revised Standardized Approach (henceforth as RSA) is based on 121 banks' data that the Committee collected during the 4th QIS in 2010, but participating banks' regional distribution information is not disclosed in the consultative document. The measurement sample doesn't include China banking industry's data, but the scale of China's banking system is very large and the amount of capital is very high. Particularly, the data of large banks will have a potentially significant impact on the sample. At the absence of China banking industry's inputs, the conclusion that "capital needs for operational risk increases in a non-linear fashion with a bank's size" remains open to question.

2. The OpCaR model in Annex 2: The OpCaR methodology is only based on same data panel in QIS4. Since loss distribution selection is greatly dependent on loss data's characteristics, in the case of poor sample representativeness, there may be significant deficiencies in OpCaR model's distribution selection and fitting, which couldn't comprehensively reflect the operational risk features of commercial banks, and couldn't ensure accurate calculation results.

Suggestion:

1. It is noted that the Committee has collected updated data for verification in second QIS of 2014, including China's main banks' loss data in recent years. Therefore, we wish to reiterate the necessity to implement quantitative verifications on the model's effectiveness and applicability as well as review the risk exposure estimate results of OpCaR model.

2. We advise the Committee, in complement to the current OpCaR model, take individual bank's actual historical loss into consideration and maintain a reasonable proportion between capital and loss.

II. Business Indicator (BI) lacks risk sensitivity

The CD concludes that the experiences and lessons of financial crisis show that the correlation between operational risk and traditional lending/borrowing business' interest income is low, while the correlation between operational risk and profits and losses of securities trading, as well as commission and fees income of payment and settlement service and securitization service is higher. Therefore, the main improvement of Business Indicator (BI) in RSA compared with Gross Income (GI) is the decrease of the weight of "interest component", in comparison to the

increase of the weight of “services component” and “financial component”. However, whether the real influence of RSA is in line with abovementioned objective is dubious.

1. Under RSA, operational risk capital requirement for “interest component” increases rather than reduces.

The scale of China banking industry is large, but its income structure is relatively simple with a high concentration on interest income. Taking 2013 data for example, the “interest component” accounts for approximately 72% of Business Indicator (BI). On the contrary, after application of Business Indicator (BI) and RSA, the operational risk capital requirement for “interest component” is increased, which is at odds with financial crisis’ experience and lessons as stated in the CD. One of our member indicated that based on the bank’s data from 2011 to 2013, the weighted average regulatory coefficient under revised SA is 20.68% while the weighted average regulatory coefficient is 20.19% when only taking the “interest component” into account (i.e. setting “services component” and “financial component” as zero). The above results demonstrate an even higher concentration on interest component and casts doubt on the CD’s initiative to seek balance between income components..

2. Provisions and Capital have already been set aside for risks stemmed from “interest component”.

It is noted that Business Indicator (BI) under RSA is comprised of three macro-components of a bank's income statement: the “interest component”, the “services component”, and the “financial component”. A majority of our member banks indicate that, based on their quantitative and management experiences, losses related to interest income usually are materialized through credit risk loss or operational risk losses related to credit risks, which have been offset by provisions and feed credit risk capital models. Similarly, when considering different business lines' operational risk losses, credit related business, in particular, should not be given equal consideration with other business lines. The reason for this is that the majority of credit business's operational risks take the form of counterparty default (i.e. credit risks), which have been considered in credit risks' regulatory capital. To charge these losses for stand alone operational risk capital charge will inevitably have the risk of double counting.

3. Cancellation of business lines classification further reduces risk sensitivity.

RSA abolishes the original practice of business lines classification, and in fact ceases to differentiate among different types of banks. We believe

that different banks vary in their business models, which are directly related to operational risk exposure. In recent years, some internationally active banks are subject to huge regulatory fines for their failed processes, covering manipulation in interest rates, foreign exchange rates and gold/silver pricing, rogue trading or deceptive sales, resulting in a huge amount of operational risk loss. However, only a limited number of international banks with concentrated distribution are engaged in the above-mentioned business. China's large banks, while equally as large as these banks, have a tiny exposure on these operational risk intensive activities and should not be weighted with them on a same par.

RSA only takes the scale of Business Indicate (BI) instead of the composition of BI into consideration, which will obviously cause certain deviation. The interest component, services component and financial component of BI under RSA is reflective of different business models, risk profile and contributions to BI. However, RSA fails to reflect operational risk characteristics of different bank business effectively and will even disincentivise a sound motivation for operational risk management.

We advise the Committee to seek a wider range of multi-dimensional factors of operational risk, with the application of new QIS. In particular,

we advise the Committee to introduce a risk-weight approach on BI components, i.e. different coefficients are applied to the interest component, services component and financial component. We envisage this to be feasible with the recently collected data. Banks using the SA must hold capital for operational risk calculated according to the following formula.

$$K_{SA} = \left[\sum_{\text{year1-3}} \sum (BI_j^i \times \alpha_j^i) + \sum (BI_j^s \times \alpha_j^s) + \sum (BI_j^f \times \alpha_j^f) \right] / 3$$

where

BI_j^i , BI_j^s , BI_j^f represent interest component, services component and financial component in Business Indicator(BI);and

α_j^i , α_j^s , α_j^f represent corresponding coefficients of the three components.

The above suggestion improves in certain important aspects, as it:

1. has better fitting degree in model;
2. has better applicability to banks across different jurisdictions(the coefficient applied to interest component should be lower ,due to the experience gained from the financial crisis) ;
3. restricts complexity of capital measurement, ensuring the framework

should be risk-sensitive but simple and the capital outcomes should be comparative;

4. has guiding significance for banks only adopting revised SA that apply different regulatory coefficients to different business lines, in terms of performance assessment and capital allocation. Because different business lines with different revenue structures need different operational risk capital, while the adoption of Advanced Measurement Approaches (AMA) requires prior supervisory approval and involves implementation of a rigorous risk management framework, including governance structure, data process and model establishment.

On the other hand, we believe that it is necessary to re-analyze operational risk differences of business lines, with updated data, thus cautiously verifying the conclusion of "the business lines did not differ significantly in terms of their operational risk profile".

Besides, we suggest that the Committee further refine and confirm calculation methodology for banks whose business models emphasize high net interest margin. In particular, the Committee is suggested to consider adjusting the current interest incomes by averaged net interest margin across different jurisdictions and then apply them to BI.

III. The calibration of regulatory coefficients and buckets is not consistent with operational risk exposure

The CD believes that capital needs for operational risk were increasing in a non-linear fashion with banks' size. The RSA introduced a set of updated regulatory coefficients in a bucketing and layered manner, reflecting the none-linear relationship between banks' size and their operational risk exposure.

As stated above, we doubt whether the above theory is applicable globally, due to the limited QIS data and samples. Under RSA, some banks in China would fall into fifth bucket with coefficients reaching 30%. However, it has been shown that their operational risk losses of these banks have not increased because their traditional credit business remained predominant. Interestingly, based on our observation, large banks have witnessed decrease of operational risk losses while it is smaller banks are more vulnerable to large operational risk loss events. We believe this to be a direct link between risk management effectiveness and risk exposure, which has been completely neglected in the CD.

Our quantitative experience also affirms that business sizes of banks (e.g. business indicator) are usually positively correlated with frequency of loss events, but limited correlation with severity of loss events. Moreover,

our capital model seven show that correlation between operational risk and size is not consistent with the conclusion in CD. The risk exposure is positively correlated with business sizes in a decreasing marginal manner (that is to say, second-scale derivative was negative). It is obviously not so that regulatory capital needs for operational risk were related with Business Indicator (BI) in an increasing marginal manner under RSA.

Besides, the RSA will greatly increase capital requirements for large banks, while AMA is adopted mainly by large banks. If the two approaches differ greatly from methods to results, it will pose additional challenge for supervisors to seek a balance and consistency.

IV. Improving the transparency of revision of new approach

The CD unveiled some conclusions during calibration process, however, related evidence disclosure was not so adequate, especially in the field of regulatory coefficients calibration and buckets threshold setting, with only overall average data being disclosed. We suggest that the Committee disclose detailed and granular QIS data (such as geographical distribution, size, and business model) and consider implementing RSA after associated parameters being periodically tested to ensure their continued validity.