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Email

Brussels, 18 December 2014

Subject: EBF Response to BCBS Consultation on Operational Risk – Revisions to the Simpler Approaches

The European Banking Federation (EBF) appreciates the opportunity to express the views of the European banking industry on this consultative paper whereby the Basel Committee puts forward policy proposals to replace the current non-model-based approaches with a Business Indicator (BI) approach for operational risk capital requirement purposes. In this response paper, the EBF presents key points that have found broad agreement among its constituency as the main aspects to consider in the Basel Committee review. In addition, numerous EBF member associations and banks are preparing their response papers, some of them including detailed elaboration on these and other aspects.

Key points

- **Coherence between current and future reforms**

In its report to the G20 of November 2014, the Basel Committee has set a general objective of '*reducing excessive variability in banks' regulatory capital ratios*'. This aims to respond to the assessment of material variances in banks' regulatory capital ratios that arise from different factors than the riskiness of banks' portfolio. In light of this development the Committee has promoted a general plan to reach this objective, on the basis of which the revision of the Operational Risk framework takes root. The next step might involve replacing the Basel II transitional floor with a permanent floor based on the Standardised Approaches for credit, market and operational risk. In consideration of this potential replacement, the actual review of the Standadised Approach becomes of crucial importance.

- **Contribution to simplicity, comparability and risk sensitivity**

We do not disagree that the use of gross income to determine operational risk capital is flawed. However we query whether the newly proposed coefficients provide a more quantitative correlation to the actual risk profile of an institution.

In the opinion of the EBF the currently proposed approaches are far from improving the combined outcome of these three factors that were rightly set as objectives in the review of risk models. In fact, both the OpCaR and Revised Standardised Approach are overly simplistic whereas the models are not risk sensitive therefore not comparable. A careful review is needed to ensure that the right balance between the three objectives is struck.

- Incentive to good risk management practices

We fear that the right incentive to good risk management practices be removed thus rendering ineffective the significant investment made by banks during the last decade. Best risk management practices stood high in the spirit of the original Basel II framework. So, the revised Standardized approach (SA) should incorporate such a mechanism to recognize in the Business Indicator (BI) expenses made by an institution to reinforce its second line of defense as defined by the BCBS in *Principles for the sound management of operational risk.* This aspect should not be negotiated with other goals.

In the revision of the approaches, we encourage the Basel Committee to ensure that there exists a link between the approaches and the incentive to good risk management practices. One way to achieve this could be the incorporation of a mitigating factor based on supervisory assessment of the quality of risk management practices. However, if a supervisory assessment element is included, the framework for such an assessment must be clearly defined in great detail and the execution must be equivalent independent of legal jurisdiction in order to secure a level playing field.

At present, irrespective of improvements made to reduce operational risk exposure, an institution will likely have to hold more capital. An incentive such as making operational risk operating expenses deductible within the proposed Business Indicators items would offer some inducement.

Annex 1 provides an opportunity to incentivise those who invest in the management of operational risk by allowing costs and expenses directly related to such activities to be a deductible under "Other operating expenses." This would be financially underpin the statement in Section III.47 which states that *strong and effective risk management and internal control processes help reduce the capital that a bank needs to hold against its operational risks.*

In addition there is currently no incentive in the proposed approach to migrate to AMA.

- Recognition of diversification

The models do not adhere to generally accepted principles of the alignment of risk management and risk measurement. The elimination of differentiation of risk by the mandatory modelling of all risk within one operational risk category (ORC) is counter-intuitive. The fundamental principle of diversification does not seem to have been regarded. On the contrary, the approaches proposed could lead to a situation whereby diversification would be assigned higher losses. We think this is conceptually unsound and should be carefully reviewed. A diversified business should not be treated the same as a non-diversified one, *ceteris paribus*. The business line approach used in current TSA has the ability to increase risk sensitiveness and provide differentiation benefits and should be carefully reviewed before being replaced.

- Consideration of Operational Risk Mitigant with Haircuts

In the new approach that is being established, there is certainly no reference to investments made with the aim of improving mitigation instruments. While we are aware that it would be complex to distinguish objectively how much of an investment is to be spent in support of new business and how much of that same investment is to cover the risks inherent in the activity, we fail to understand why it is not possible to apply haircuts to such investments so that they might, at least to a small extent, be recognised as elements deducted from BI, thereby rendering the method more risk sensitive overall.

- Regarding the Business Indicator (BI)

We are in disagreement with the inclusion of Net P&L Banking Book in the BI due to the following reasons:

- In CRR (Art. 136, 1.b.) profit and losses associated to the sale of non-trading book instruments are explicitly excluded;
- Operational risk in the generation of this kind of results is very low, being limited to errors in the transaction;
- It is not in our view an operational risk driver, yet it has a significant weigh within the BI, thus reducing the metric sensitivity and the comparability among banks.

Apart from removing risk sensitivity the BI presents several hitches that should be sorted out:

- In general the BI should be calculated with net values instead of the sum of components in absolute terms;
- The BI tends to penalise profitable banks through the interest component although profitability acts as a protecting factor against future losses;
- Banks highly specialised in fee businesses, in particular custodian banks, would also be severely impacted. The correlation between fee and commission income and expenses should be carefully evaluated, since, for example, in the case of fee and commission income for services rendered on payment systems the rebates granted to international circuits, when added to the initial income component, could result in double counting of the transactions, with the resulting overestimate of operational risk. A less harmful approach would consist in netting the fees income and fees expenses in the calculation of the services component of the BI;
- Similarly, the leasing asset class would be overly penalised by including leasing income and leasing expenses in other operating income and other operating expenses;
- We alternatively propose to consider at consolidated level a waiver for payment institutions that already pay their individual capital requirement with their ad-hoc criteria.
- Another alternative could be that the interest component be extended to "economically similar income". If a bank has its main focus on fee business or leasing business, it should be allowed to recognize these income and expenses as a netting position. We also propose referring to the service component a maximum approach, which means, the service component considers the fee income or the fee expenses, whichever is higher, plus other operating income or other operating expenses, whichever is higher. The formula would be:

  Service component = max (fee income; fee expenses) + max (other operating income; other operating expenses);

The advantage would be, that a business transaction would not be taken into account twice if the transaction produced income and expenses. On the other hand, a business transaction (income) where the bank has taken risk mitigation measures (expenses) would not be penalized for these measures;

- The inclusion of items (e.g., "Profits/losses on the sale or repurchase of available-for-sale and held-to-maturity financial assets") deriving from merely financial choices could result in distorting effects in the estimate of the absorption of operational risk;
- Intragroup transactions should be excluded from the BI calculation;
- The text is unclear on the coefficient to apply to institution using a hybrid approach, i.e. having the bulk of its entities under the AMA and the remaining part under a simpler approach.

- Basis of new approach

It is noted that the sample of banks reduced in size from 270 to 89 banks. We would appreciate clarification of the rationale for scoping out institutions from the sample? This would aid transparency and provide comfort that an appropriately representative data set has been used. At present there is no transparency over the actual data used to facilitate informed challenge on the calculations /assumptions made.

Much of the information used was collected in a QIS study which captured data from before the worst of the crisis. It would be useful to know how more recent loss data across the industry would impact on the calculations.

- Clarity of understanding

We seek clarity on the definition of certain incident data e.g. near misses, opportunity costs / lost revenues, insurance recoveries & timings (Annex 4 A Loss data collection). The prescribed method of how Banks should capture boundary loss data (e.g. credit risk and market risk) has not yet been clarified to a point whereby it is clearly understood and can be applied without unnecessary double counting of data (and capital). Similarly guidance on inter / intra accounting period loss data collection would benefit from a greater degree of clarity and so consistency of understanding and of application.

Clarity on all terminology would avoid misinterpretation/manipulation of the business indicator calculation (specific reference to 'fees').

- How much is enough? Adding up to the overall impact

At this point of the regulatory reform, banks at large have recapitalised from the outset of the crisis and the European financial industry has substantially increased capital buffers. The rationale of additional capital requirements should be cautiously scrutinized in order to prevent side effects. It is well recognized that unnecessary capital requirements will lead to credit shrinkages and shift of risk to unregulated areas.

Against this background, we note that the proposals, as they have been put forward in the consultative paper, lead inevitable to significantly increased capital for operational risk without evidence of any perceptible increase in operational risk exposures. Estimates of individual banks indicate that the total operational risk requirement could be more than double under the current proposal. Should the BCBS Quantitative Impact Study confirm this assumption the proposal would need to be critically reviewed and, ultimately, tone down.

The BCBS Quantitative Impact Study should also carefully review the interaction of the new proposal with the current implementation of combined buffer requirements.

We are particularly concerned with the statement of an "average under-calibration" obtained by applying the TSA, BIA and ASA requirements and the ensuing underestimation of the AMA values obtained using the requirements with the simplified methods as benchmarks. We would like to ask the Committee to provide explicit estimates of the level of under-calibration observed, for both the TSA, BIA and ASA scope, as well as for the AMA scope, so as to allow banks to obtain a better assessment of the impacts of the new calculation rule.

Before the above issues have been adequately addressed, the proposed adjustments should be postponed.

- 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.