



A response by the Latin American Bankers Federation – FELABAN to the Basel Committee on Banking Supervision’s consultative document on:

Standardised Measurement Approach for Operational Risk

Dear Basel Committee on Banking Supervision members:

The Latin American Bankers Federation (*Federación Latinoamericana de Bancos – FELABAN*) acknowledges the Basel Committee on Banking Supervision for the opportunity to analyse and discuss the proposals included in the “Standardised Measurement Approach for Operational Risk” consultative document, published in March 2016.

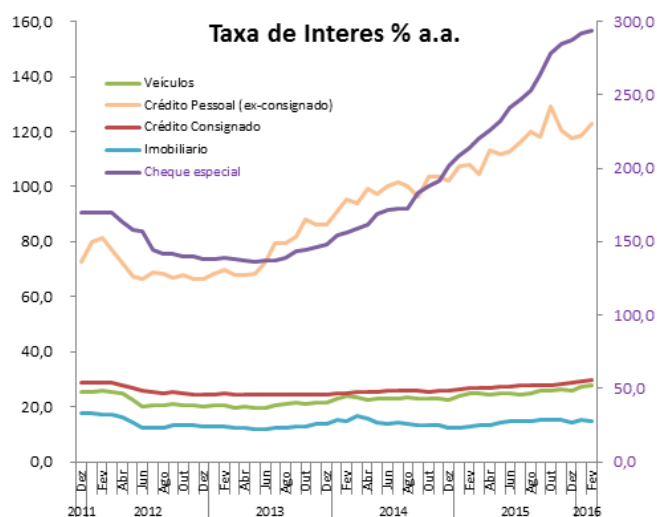
The Latin American banking sector recognises the Committee’s effort and initiatives aimed to strengthen operational risk management worldwide, and celebrates the joint debate with the banking sector. Thus, and after a consultation and discussion with the banking associations we represent, FELABAN puts forward for the Committee’s consideration some key aspects regarding the proposals included in this consultative document, aiming to enrich the discussion around the Standardised Measurement Approach from the point of view of our region’s banking sector.

Key comments

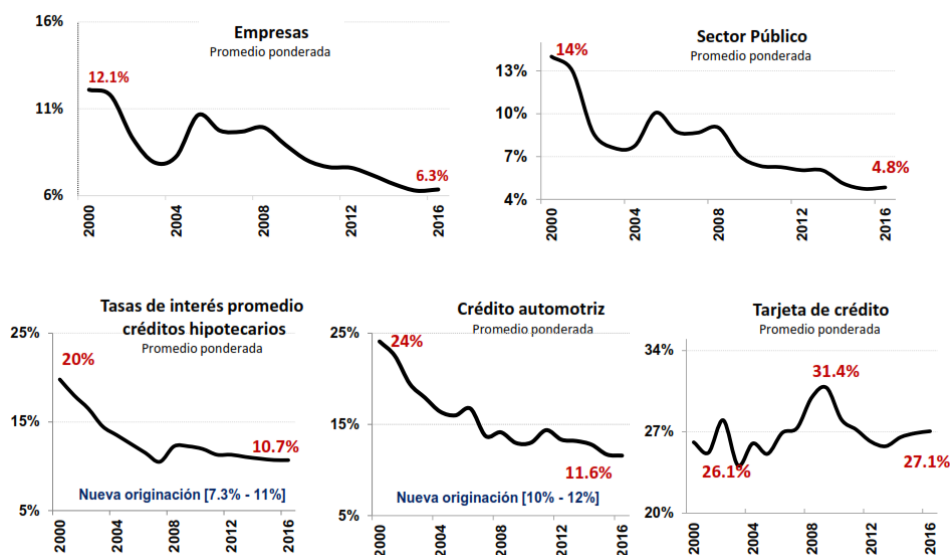
SMA implies a significant increase in the amount of capital to be allocated to operational risk. This is observed in banks that are using any options actually available for measuring operational risk and is the opposite of the objective of the proposal to preserve overall capital requirements.

The interest rates prevailing in credit transactions in Latin America and, consequently, its net interest margins are among the highest in the world in all segments. As an example, the risk-free rate in Brazil that remunerates Brazilian government securities, *Selic*, currently stands at 14.25% p.a. and, similarly, Colombia's Central Bank intervention rate is 7.25% p.a., which raises the hurdle rate demanded by shareholders, as well as interest rates and spreads charged on financial intermediation activities.

Our region as a whole also has several peculiarities, such as taxation on intermediation, high levels of mandatory earmarked lending, mandatory reserve requirement and restrictive criteria on provisioning. The most part of these factors impact the interest rates and spreads in our region's countries, but some of them are not considered in the SMA's methodology like taxes, mandatory reserves, provisions for credit risk and, in other way, the level of provisions for operational risk increases the capital required in the SMA methodology. Despite the high net interest margin, the level of profitability of the banks in Latin America would be aligned to the one of the rest of the world.



Historical evolution of interest rates in Brazil. The green line denotes the one for vehicle loans; the orange one for retail loans; the red one for payroll loans; the blue one for mortgage loans; and the purple one for overdrafts. Source: Federação Brasileira de Bancos – FEBRABAN.



Historical evolution of interest rates (weighted averages) in Mexico. From left to right and from top to bottom: Corporate loans, public corporate loans, mortgage loans, vehicle loans, and retail credit cards. Source: Asociación de Bancos de México – ABM.

As a result of these economic and financial peculiarities and of the fact that some banks have expected losses more dominant than unexpected losses due to peculiarities of the local environment, in Latin America the capital requirement under the proposed SMA could reach 3 to 6 times the current level, and the projected share of operational risk would be for some banks above 30% of total RWAs. This increase in the capital requirements is even more relevant for bigger banks in higher BI buckets, regardless of the buffers that SIBs already have in place.

The effect in terms of capital will have an immediate translation into the real economy and into the credit market through the pricing of financial instruments, influencing strategic decisions (i.e. to avoid going up the BI buckets in M&A operations), and will make decision makers more wary of investing in operational risk management.

This will be more critical in emerging markets that experience a faster credit growth due to the recent process of financial inclusion. The results published by World Bank Group's *Global Findex Database 2014* point out that only 51% of Latin American population has some sort of link with the formal financial sector, which evidences the challenges our countries face with respect to improving this financial inclusion levels regardless of the significant improvements obtained during the last years. However, the implicit cost of the potential impact of increasing regulatory capital requirements for operational risk can be transmitted to the credit market through higher active

interest rates or new/higher restrictions to lending to the economically more vulnerable sectors. In other words, the impact of these proposals has a potential negative impact in the financial inclusion efforts led by our region's countries.

Separately, we consider the proposed SMA does not fully achieve the desirable level of comparability. The replacement of all methods currently in use by a single "one size fits all" approach does not properly capture the different operational risk levels of different business models, different business lines, and different countries (as the main events of operational risk are closely related to the specific regulatory and legal environment of each country, such as conduct issues in UK, fine amounts in USA, employment rules in some countries in Latin America, etc.). Moreover, the proposed changes are implicitly not taking into account the learning curve gained (in terms of operational risk databases, methodology, and human resources) by those banks who have used AMA models to calculate their operational risk capital requirements during the last years, which implies that the implementation of these proposals has a very high opportunity cost.

Some elements of the SMA formula may differ among banks. There is no clear/homogeneous definition of what should be considered an operational loss for the LC - there might be different accounting criteria for booking those contingent losses, or banks in different countries might even apply different accounting GAAPs that would affect both the BI and the LC. This would create problems at the time of aggregating the LC components in banks with significant international activity.

At the same time, we consider that a significant weakness of the current BIA approach is the use of gross income because, as the Committee stated in October 2014 (via the consultative document *Operational Risk – Revisions to the simpler approaches*), it is not an appropriate proxy indicator for operational risk exposure. However, and similarly to the BIA, the proposed SMA considers this item in the BI calculation as well – although under a more granular approach. So far, we do not know any theoretical or empirical study that demonstrates a direct relationship between a bank's exposure to operational risk and its size – measured by its gross income and expenses, nor even that such relationship is constant over time, to justify the use of a bank's P&L indicators to determine its operational risk capital requirements.

Finally, with regard to the mathematical equation proposed to determine the operational risk capital requirements under the SMA, we consider that the use of averages in such calculation goes against the experience gained by the banking sector during the last years. Particularly, operational

risk management focuses on mitigating the impact of events with low occurrence probability but with high severity and, given the statistical problems associated to an arithmetic average calculation (inconsistencies when outliers are present, and non-concluding calculations in skewed data distributions), we consider that this approach inherently underestimates the impact of these kind of events and, consequently, diminishes its risk sensitivity.

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

Due to the peculiar business model of some banks in Latin America, the BI is deemed to be overstated for these banks, causing them to be outliers in the regression of OpCaR capital vs. BI. As an example, our analysis shows that the Interest Component is the dominant one in the BI calculation for Brazilian banks.

In order to level the playing field for banks and/or regions with high NIM business model, the SMA imposes a cap of 3.5% on IEA (Interest Earning Assets) on BI's calibration. We consider this cap has insufficient impact on banks that operate in countries with high net interest margin (e.g. Brazil, Mexico and Colombia, in our region). The reason is that the aggregate IEA of most banks consists of several classes of assets with fundamentally different NIM levels, which is the particular case in well-diversified banks with heterogeneous lines of business.

We consider that the BI Component (particularly the Interest Component) of the SMA can be adjusted by adopting a more granular approach in applying a cap on NIM.

An ideal solution would be to apply the cap on NIM for each line of business or class of assets separately. This could level the playing field across banks with different business mixes and would eliminate conflicting incentives while maintaining a conservative level of LCR (Liquidity Coverage Ratio).

We do acknowledge however, that adopting a highly granular approach in calibration of BI may lead to practical complexities and would generally be in conflict with the objective of simplicity (one of the main driving motivations behind the SMA capital model). Therefore, we kindly submit to the Committee two proposals to adjust calibration of the BI while preserving the simplicity of this approach' formulation:

- Excluding the low-risk components of the Interest-Earning Assets (IEA): as previously indicated, the low-yield components form a considerable share of the IEA in well-diversified banks, and we consider that some of these components can be safely considered virtually risk-free from an operational risk point of view. Applying the same cap (e.g. 3.5%) to the low-risk/low-yield components of the IEA dilutes the result and leads to an overstatement of the Interest Component for Latin American banks. Examples of potential low-risk components which can be excluded from the IEA are (but not limited to): compulsory deposits, sovereign debt, short term interbank exposures, and fixed-income securities.
- Reducing the 3.5%*IEA cap on NIM to 2.5% or 2.0%: we acknowledge the fact that excluding the low-risk components of the IEA could lead to some practical complexities or inconsistencies across different jurisdictions. An alternative way of achieving the same goal is to keep IEA as they currently are, but reducing the 3.5% cap. As an example, the IEA's breakdown for Brazilian banks shows that around 20% to 40% of its IEA may be considered risk-free from an operational risk point of view. Reducing the 3.5% cap by the same percentage would result in modified caps of ~2.0% to ~2.5%.

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?
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In general, the Latin America banking sector considers the inclusion of banks' specific loss data as positive, although the exclusive use of historical data does not help or incentivise banks to improve the strength of its processes and controls. Our major concern lies in that the risk sensitivity of loss data inclusion is limited to past losses, and does not consider in any way a foreseeable analysis of the future evolution of operational risk losses – e.g. the loss data structure is *backward looking*.

The capital measure includes an averaged historic losses component to guarantee capital allocation to those business lines that present higher operational risk losses. We kindly suggest the Committee to reconsider this proposal as: 1) It aims to cover the high-frequency, low-impact operational risk events instead of the extreme ones, therefore we consider this proposal lacks

prospective by not considering those high-impact risks that may occur but have not materialized yet; and 2) under the assumption of calculating the average of past operational risk losses it is being also assumed that they will exhibit a similar pattern in the future, and we consider it cannot be concluded that operational risk losses follow a stationary process.

Separately, operational risk management is relatively recent and, consequently, few jurisdictions have a robust 10-year operational risk loss data (in fact, some of the countries in our region are still in a transition process to Basel II standards). As an example, Colombia's financial regulator implemented the *SARO – Sistema de Administración de Riesgo Operativo* (Operational Risk Management System, Colombia's Operational Risk regulatory framework) in 2007, and during its early implementation stages the reported information was not as robust as initially expected. In fact, some countries do not even have a historical operational risk loss data. These kind of situations evidently complicate SMA's implementation in many of our jurisdictions, at least in a clear and objective way.

To improve the methodology, we suggest:

- a) Exclusion of the expected losses from the LC. Operational risk capital requirements were calibrated considering both expected and unexpected losses, and therefore the EL should be deducted from the SMA capital requirements. Moreover, the EL should be excluded from the Loss Component of the SMA as well as the Other Operating Expenses (OOE), which is one of the contributors to the Service Component of the BI. Practically, finding the true EL is not a straightforward task as it requires complex statistical techniques (similar to the one used in OpCaR). The expected loss can be accounted for through approximation by the following two alternatives
 - a. Provisions for operational risk losses: provisions for operational losses, particularly for labour and civil lawsuits, may be deemed as reasonable proxies for the EL. However, there may be some practical complexities with proxying the EL with the provisions given the variations of provisioning in different jurisdictions and the general regulatory concerns on potential inconsistencies arising from provisions (e.g. time differences to losses and effect of provisions for large losses)..
 - b. Smaller losses: another proxy for the EL could be the smaller losses which are also usually provisioned for by the banks. The operational loss of some banks is dominated by high-frequency/low-severity civil and labour lawsuits and tends to

be stable and fairly predictable. Consequently, the expected component of loss tends to be larger than the unexpected one ($EL > UL$). Considering the fact that smaller losses tend to have higher frequency and be more stable and predictable, losses below the €100K threshold may be used as a proxy for the EL.

- b) Reducing the multiplier for small losses in the Loss Component to 3: the current formula for SMA loss component is $LC = (7 \times \bar{L}) + (7 \times \bar{L}_{>10}) + (5 \times \bar{L}_{>100})$, where $\bar{L}$ denotes the 10-year average annual loss (for all losses, and those above EUR 10 million and EUR 100 million). The current coefficients are calibrated for losses with heavy-tailed severity distributions where EL are significantly smaller than UL. For banks with thin-tailed (more predictable) loss profiles with the UL being less than half of the EL, the multiplier for the first tier of losses ($\bar{L}$ but not those of $\bar{L}_{>10}$ and $\bar{L}_{>100}$) can be safely reduced to below 3. In order to test the conservativeness of the proposal, we changed the multiplier of the first tier of losses from 0 to 7 and for each value of the multiplier, we measured the probability of LC being larger than the capital through a Monte-Carlo simulation (an empirical bootstrapping from the historically-observed loss events). The capital was defined as the 99.9-percentile on the empirical distribution of the annual loss. Even when losses below the EUR 100.000 are excluded from $\bar{L}$, LC exceeds the capital with a probability of 100% (>99.9%) when the multiplier is above 2. Therefore, we consider a multiplier value of 3 is sufficiently conservative even when the inclusion threshold is raised to EUR 100.000.
- c) Include a forward-looking view on the capital charge to provide a real incentive for banks to improve operational risk management, introducing in the formula correlated to Scenario Analysis a new factor determined for each bank by supervisory judgement.
- d) Consider loss recoveries due to management efforts and insurance policies as they reduce effectively the amount of losses that hit a bank's P&L and consequently the capital impact of those losses. Similarly, deduct from the capital requirements for operational risk the amounts already insured or include in the LC the losses net of the insured amounts (after accounting for insured amounts and its respective recovery).
- e) Reconsider the use of averages for calculating LC. The experience gained by the banking sector throughout the last years evidences that operational risk management deals with the impact of low frequency, high impact events. Therefore, the corresponding capital requirements should cover these events, instead of the high-frequency, low-impact ones.

However, given that the LC considers averages, tends to minimize the impact of these kind of events, which diminishes its risk sensitivity.

At the same time, the occurrence of high impact events have a significant impact on capital requirements and, given the use of average and the time frame required to compute the LC, its impact would take many years to fade away (because of the outliers' statistical effect in an arithmetic average), even when the required controls to avoid its future occurrence have been successfully implemented.

Generally, we consider that risk sensitivity significantly decreases when averages are used, given that they would not be sensitive to the extreme variations frequently observed on operational risk losses. This would make matching risk tolerance and risk appetite a more difficult task.

- f) Reconsider the proposal of treating operational risk losses related to market risk as operational risk for the purposes of calculating minimum regulatory capital under the SMA. Our concern lies in the fact that such losses are already being considered in the current capital requirements for market risk; therefore, this proposal would imply a double capital surcharge for the same concept.
- g) Consider a phase in on SMA implementation. With regard to the adaptation of the banking sector to the potential impacts of SMA implementation, as well as the historical operational risk database required, we believe it is important to consider a longer timeframe for the implementation of this new operational risk framework. We have several new regulations in the pipeline and it is important to smooth the impacts and avoid abrupt changes in economics and financial structures. Considering the release of the final standard in the first quarter of 2017, we propose a transition period of implementation between 2019 and 2022, which is in line with the grandfathering of subordinated debt, according to Basel III implementation schedule.

Separately, regarding the SMA application within a group, we consider that such application should be weighted by the participation of each entity in the consolidated group, instead of accounting by the sum of the operational risk capital requirements only. This, because using this approach (which includes consolidated figures), although marginally affects the subsidiary entities, strongly penalizes the Head Office in terms of regulatory capital.

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?

In this early stage consultation, we have no comments with respect to this alternative approach. However, we look forward to its development in further discussions on the regulatory framework of operational risk management.

FELABAN wishes to thank the Committee for having considered the above comments made on behalf of the Latin American banking sector, and hopes they enrich the development of a new operational risk management approach characterised by its risk sensitivity, its simplicity and its comparability. We look forward both to provide further clarifications if required, and to participate in subsequent discussions on this topic as well.

Very truly yours,

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General Secretary

Latin American Bankers Federation