Finaxium answer to the BCBS consultation on Revisions to the simpler Operational Risk approaches

We would like to thank the BCBS for this opportunity to comment on the proposed revised approach. We also welcome the revision of the former approaches, which sometimes lead to very counter-intuitive results (we happened to come across negative TSA capital requirements). We understand that the proposed document aims at revising the BIA, TSA and ASA approaches, with no effect on banks which have already chosen the AMA approach (other than potential future recalibration effects). Therefore, our answer is mainly focused on evaluating the appropriateness of the new approach for banks with likely lower operational risk awareness and collection process than AMA banks.

Answers to the BCBS questions

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

We did not identify any significant weakness which was not already addressed by the revised approach.

Q2 – Does a single standardized approach strike an appropriate balance across the Committee's objectives of simplicity, comparability and risk sensitivity?

Yes, a single standardized approach is appropriate. Given that, in order to reach a workable model, the committee already had to filter out a large part of its data collection basis, defining several models would only reduce the workable basis, and therefore the representativeness of each model.

Q3 – Are there any further improvements to the BI that should be considered by the committee?

Although the BI is a more efficient indicator than the GI, in particular by the use of absolute values, we believe that the list of sub-items which enter into the three components of the BI could be improved. In particular, we have some questions about items explicitly excluded from the BI as per annex 1.

For example, we see in annex 1 that "operational risk events" are taken into account in the "services" component of the BI, except if provisioned, while impairments and provisions (including for operational risks events) are not. In our understanding, this means that banks which provision their operational risk events would exclude them from the BI, and therefore from the OR capital calculation, while banks booking their OR events directly in P/L would include them in the calculation. Since the difference depends mainly on accounting practices and on the timeline and detection of events, we fail to see why the impact on the OR capital calculation should be different. In the worst case, it would lead to an accounting arbitrage on how to book OR events in P/L in order to minimize the BI.

Regarding the inclusion / exclusion of impairments and provisions in the BI, we also have another concern, related to the case of high/low interest margins (also raised in question Q8). One of the key rules of risk management is the risk/reward principle, which usually leads to adapting margins to the risk level of each counterparty/portfolio/activity. Based on this principle, a high interest margin activity is usually compensated by a high impairment level (and conversely a low interest margin activity by a low impairment level). In the case where a high interest margin/earnings activity would come along with a low impairment level, this would likely be the warning signal of an underestimated (i.e. non-recognized) risk, often under the form of operational risk building-up (e.g. subprime activity, falsified market operations). On the contrary, high interest margins coming along with high impairment levels would just reflect a normally managed riskier activity in a bank's portfolio, with no particular alert on the operational risk level. For these reasons, we believe that the NI (or other BI component) **net of impairments/provisions** might be a better indicator than the gross NI, because it would consider the link between operational risk and earnings, net of already recognized risks.

Q4 – What additional work should the committee perform to assess the appropriateness of operational risk capital levels?

As mentioned by the committee in the consultative document, banks using standardized approaches usually collect operational losses less efficiently than AMA banks. Indeed, based on the published results of the loss data collection exercise, we see that AMA banks, representing 35% of the participants, report 71% of the total number of collected losses and 87% of the total loss amount.

If the losses of the pool used to calibrate the OR model were taken into account non-adjusted, knowing that AMA banks are usually bigger than non-AMA, this could account significantly for the increase of losses vs size identified by the committee. Indeed, in the absence of adjustment to non-AMA results, the non-linear increase of losses by bank size could come for a large part from a higher proportion of AMA banks among the bigger size banks.

We therefore believe that the committee could perform one more test, in order to adjust loss figures of non-AMA banks. By comparing the loss collection results of two similar sets of banks (similar by size and activity), one AMA and one non-AMA, the committee could identify an adjustment factor in the loss collection of non-AMA banks, making their results nearer from what they would have been if collected through a more thorough process.

The calibration of the model could then be performed on a homogenous set of losses, made of non-adjusted AMA losses and adjusted non-AMA losses.

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?

In our opinion, the first requirement when working with buckets is to avoid cliff effects, in order to prevent "adjustments" aiming at keeping the BI in the lower buckets. This approach being already followed in the proposal, the second requirement is to keep a number of buckets sufficiently high to avoid a slope effect between buckets (fig. 1). Based on the proposed coefficients and number of buckets, the capital requirement curve is rather linear (fig. 2), which means that the number of buckets as presented in the document, given the currently calculated coefficients, is sufficient to avoid slope effects.

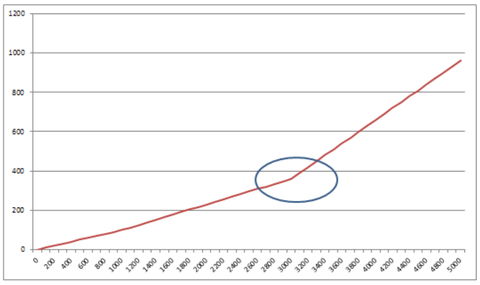

Fig. 1

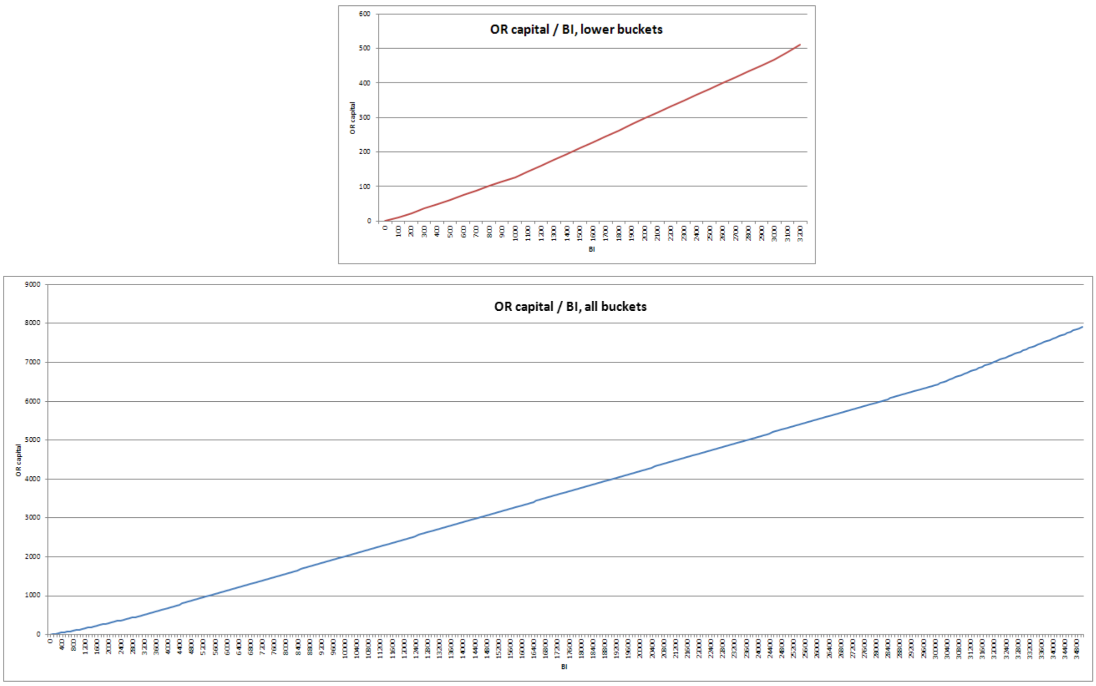

Fig. 2

Q6 – Are there any other considerations that should be taken into account when replacing business lines with size-based buckets?

We understand that the committee focused on the size criterion because it was identified, when looking at the historical OR losses, as the main differentiation source of coefficient to BI. We also understand that the coefficient of losses to BI by individual business lines did not differ significantly, which lead the committee to abandon the business line criteria. However, we believe that there is one additional criterion, partially linked with size and business lines, which the committee could consider when determining buckets: it is the diversification of activities.

The reasoning behind this suggestion is as follows: when a bank is specialized on one business line, regardless of its size, there is no reason why the potential for operational losses should be proportionally higher than that of a smaller bank of the same specialty. On the opposite, when a bank manages several business lines, it is unavoidable that operational risks will be less efficiently managed in some business lines than others. Unlike what happens with credit risk, where diversification lowers the risk by spreading it across different sources, with operational risk, diversification of business lines multiplies the sources of potential deficiencies in procedures and controls, as well as the exposure to external events.

We would therefore suggest that the committee, before finalizing the replacement of business lines buckets by size-based buckets, evaluate whether a diversification criteria could also enter into the definition of the buckets, for instance by comparing the operational losses of diversified vs. specialized banks of similar size.

Q7 – Could there be any implementation challenges in the proposed layered approach?

We do not believe that there would be any technical implementation challenge in the proposed layered approach. We believe however, that due to high increase of OR capital which the new calculation will imply for bigger banks, the new approach may accelerate an evolution towards AMA for the most impacted banks.

Q8 – Do the issues of high interest margin and highly fee specialized businesses in some jurisdictions need special attention by the committee? What could be other approaches to addressing these issues?

Regarding high interest margin and high fees, please see answer to question Q3. We believe that interest margin net of impairments and provisions should be used, in which case high interest margin would likely reflect high operational risk, and therefore require no specific treatment.

Q9 – What would be the most effective approach to promoting rigorous operational risk management at banks, particularly large banks?

We believe that the most effective approach to promoting rigorous operational risk management would combine reward for efficient risk management and sanctions for failure. Otherwise said, banks may be keener on implementing the necessary improvements when both savings can be foreseen as a result of these changes, and fines foreseen as a result of not implementing them. In this view, the most effective approach to promoting rigorous operational risk management would be the combination of:

- Precise guidelines, distinguishing between mandatory implementation, additional requirements for specific activities (and/or size, and/or international activity, …) and optional but recommended measures
- Additional OR capital, under the form of an increased coefficient, for banks found failing on mandatory implementation (or additional requirements if relevant) and until full compliance
- Possible OR capital buffer for specific concerns
- Possible negative OR capital buffer for banks found fully in control of OR risk (on mandatory and optional measures, including governance and loss collection)

As a conclusion, we consider that, if the calculation of the OR capital coefficients per buckets could be further improved, the proposed approach is a very adequate replacement to the former approaches. We also believe that the implementation of the new approach could prompt further improvements of banks' operational risk management towards AMA, and that a smoother transition between standardized and advanced approaches could be encouraged.

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