



FIRSTRAND

Comments on BCBS D355 – Standardised Measurement Approach for
operational risk

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Document control

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1. Introduction

FirstRand was invited to provide comments on BCBS D355 – Standardised Measurement Approach for operational risk, issued by the Basel Committee on Banking Supervision (BCBS) in March 2016. This document presents FirstRand's comments and recommendations. Comments on individual paragraphs in the document are provided, as well as general comments on the proposed Standardised Measurement Approach (SMA).

2. General comments on proposed SMA

This section of the document provides general comments on BCBS D355 – Standardised Measurement Approach for operational risk.

Impact on risk management

SMA capital is mainly based on financial items in the income statement and balance sheet, with larger banks permitted to use internal loss experience to make limited adjustments to capital derived from these financial items. As a result, banks' internal risk measures, apart from internal loss data, are not used in capital calculations. This disconnect between risk measurement and SMA capital requirements may have the unintended consequence that senior management will place less focus and priority on operational risk measurement and management. Over time this may lead to higher operational risk exposures and losses.

Costs of AMA

While mention has been made of the limited benefit of AMA versus the investment banks have made in internal models over the past decade, the benefits of AMA from a risk management perspective appear to have been under-estimated. Banks have embarked on major risk management programmes/projects and employed additional resources to enhance their risk management practices as part of their AMA implementation which have yielded and continue to yield many operational risk management benefits. These costs to banks are far greater than the costs of implementing and maintaining the internal models to banks. The limited risk sensitivity of the SMA as it stands potentially places banks at risk of not fully realising the benefit of the investments in risk management already made under the AMA.

SMA to address AMA shortcomings

Various AMA shortcomings are mentioned, including diverse practices, variability in capital numbers, complexity and lack of comparability. It is stated that SMA is introduced to address these shortcomings (refer for example to section 2, paragraphs 6 and 7). However, SMA may not address all the drawbacks of AMA mentioned in the document. Capital calculation complexity will

be addressed by SMA, but not diverse practices, variability in capital numbers and lack of comparability. Banks will interpret SMA BI items differently, map different financial statement items to BI items, use different currency conversion rates etc. In addition, different accounting standards are applied across different jurisdictions. This may lead to incomparable capital numbers and diverse ranges of practices.

SMA calibrated with AMA

SMA was calibrated using QIS exercise outputs, which in turn used AMA model inputs and outputs. This implies that AMA models were viewed as good measures of tail risk and required capital, which is contradictory to the BCBS view expressed in the consultative paper that AMA models have various shortcomings and is not appropriate for operational risk capital calculations.

References to risk sensitivity

Various references are made to the sufficient risk sensitivity of SMA (refer for example to paragraphs 2, 3, 7, 10, 13, 14, 17, 29 and 47). SMA's risk sensitivity is limited, based on relationships derived between financial items and risk measures, and the use of internal loss history. It is proposed that references to risk sensitivity of SMA be removed, or changed to reflect the limited risk sensitivity of SMA. Focus should rather be placed on the main purposes or desired characteristics of SMA, which is simplicity and comparability (and not risk sensitivity).

Greater risk sensitivity, however, can be achieved through the inclusion of forward looking risk measurement elements in SMA, so that it better reflects the risk profile of the business given emerging risks (that are not reflected in the loss history), risk mitigation programmes put in place and the risk benefits being realised (example: improved controls) as a result thereof. The inclusion of a forward looking view will assist in ensuring the continued maturity of operational risk management practices and will drive risk management culture within banks.

Business indicator risk sensitivity

BI items do not necessarily reflect the inherent operational risk in specific types of businesses. Even though this shortcoming is partially addressed in the SMA calculation formula, it may result in the capital requirements not being in line with the inherent riskiness of the underlying business.

Simplicity of SMA

The main goals of SMA are simplicity and comparability. However, the construction of the business indicator, and sourcing of appropriate data, is not simple. The inherent complexities of the business indicator may, to some extent, prevent the Committee to achieve its objectives in terms of simplicity and comparability.

Pillar II Requirements

BCBS should make some reference to Pillar II capital requirements and its stance. Where local regulators will have the discretion to determine these requirements, same must be clear.

3. Comments on specific BCBS D355 paragraphs

This section of the document provides comments on specific paragraphs of BCBS D355. In each instance, reference will be made to the relevant paragraph and page number of the document.

Paragraph 1, PDF page 5

It is stated that the Committee embarked on a review of the costs and benefits of the Advanced Measurement Approaches (AMA) for operational risk, and it is assumed that the outcomes of this study contributed to the removal of AMA. As the largest portion of costs associated with AMA relates to general measurement and management, and not modelling, this can be interpreted that the Committee does not see value in the advanced management of operational risk. This may send the wrong message to banks and have various negative consequences. It is therefore proposed that this sentence (i.e. costs and benefits of AMA) be removed from the document.

Paragraph 14, PDF page 7

The document states that the introduction of the loss component into the framework not only enhances the SMA's risk sensitivity, but also provides incentives for banks to improve operational risk management. It is FirstRand's view that the loss component will not incentivise banks to have complete operational risk measurement and management systems, but only to focus on losses. Due to the impact of large losses on SMA calculations, banks may be incentivised not to report larger losses, which may have a negative impact on the management of losses and operational risk in general.

Paragraphs 15 to 24 (section 4.1), PDF page 7

More detailed guidance is required on what income statement and balance sheet items that should be included (or excluded) in the BI. Examples of where more guidance is required are financial and operational lease income and expenses, and net profit / loss on the trading and banking book respectively. This is required to create consistency and comparability between banks, and may be achieved by local regulators providing detailed guidance or rules to banks in their jurisdiction.

Paragraph 25, PDF page 9

In this paragraph it is stated that the BI Component reflects the operational loss exposure of an average QIS bank of a given BI size. Later in the document (paragraph 33) it is stated that a bank with the Loss Component equal to the BI Component is a bank with exposure at the average of the industry. This implies that the operational loss exposure mentioned in paragraph 29 is measured by the Loss Component. It is proposed that Loss Component be defined earlier in the document (paragraph 29) to confirm the relationship between Loss Component, BI Component and loss exposure before the introduction of calculation formulae.

Paragraph 27, PDF page 10

Currency conversions applied to BI ranges and components may have a significant impact on SMA capital requirements, especially for countries with volatile currencies. This may lead to unwanted capital volatility which is not in line with the bank's true operational risk exposure. It is proposed that BCBS allow local regulators to provide detailed guidance or rules to banks in their jurisdiction with regards to currency conversions to ensure consistency and comparability between banks, and minimise the effect of currency fluctuations.

Paragraphs 37 to 39 (section 5), PDF page 12

Banks will require more guidance on the level of application and calculation of SMA capital requirements.

Paragraph 42, PDF page 13

This paragraph states that the Committee continues to encourage all banks, irrespective of the use of the Loss Component under the SMA, to comply with the Committee's Principles for the Sound Management of Operational Risk (PSMOR) published in 2011 under Pillar 1. Banks may view this requirement as optional, due to the use of the word "encourage". If the Committee's intention is that all banks should comply with PSMOR, it is proposed that the word "should" be used instead.

The Committee should be clear on the importance of the PSMOR going forward to ensure that operational risk management standards remain high. It is understood that the Committee is reviewing the PSMOR. It is suggested this review be prioritised, so that there is finalisation of the new PSMOR together with SMA to enable banks to introduce necessary changes or maintain current risk measurement and management practices simultaneously and not lose momentum on risk management initiatives while implementing the SMA.

Paragraph 43, PDF page 13

Gross loss and net loss are both discussed in this paragraph. However, it is not stated whether gross loss or net loss should be used in SMA calculations. It is proposed that the document clearly states whether gross- or net loss should be used. If net loss should be used in calculations, a clear definition will be required (for example net of non-insurance recoveries). It was further noted that loss definitions are not consistent for SMA and QIS (example: QIS refers to risk mitigants, while SMA does not reference this term), and the alignment of definitions in various relevant BCBS publications is proposed.

Paragraph 43, PDF page 14

It is stated that losses and provisions or reserves accounted for in the P&L against the potential operational loss impact should be included in the SMA loss dataset. The second part of this statement is not clear (i.e. "...against the potential operational loss impact...") and it is proposed that this part be removed. These items are also included in the business indicator under "Other operating expenses". The inclusion of losses and provisions in the business indicator and loss component may lead to potential double counting of a bank's losses in SMA capital calculations.

It is further requested that the Committee clarifies whether the same data sources for operational losses (for example loss database vs. income statement entries) should be used in the BI and Loss Component respectively.

Annex 1, PDF page 16

Based on the table provided in Annex 1, interest and non-interest income / expense from financial and operating leases should be excluded from interest income / expense and other operating income / expense respectively. It is assumed that these items will be covered in the financial and operating lease income / expense sections. However, the description of financial and operating lease income / expense only includes interest items, which seems inconsistent with the exclusion of non-interest lease items from other operating income / expense. Clarity on the inclusion and exclusion of financial and operating lease income / expense items is requested.

More detailed guidance is required on the Financial BI Component to ensure the inclusion and exclusion of correct financial statement items in net profit / loss on the trading book and banking book respectively. This is required to ensure consistency and comparability between banks. It is proposed that the Committee provides more guidance on these items, or allow local regulators to provide detailed guidance or rules to banks in their jurisdiction.

4. Conclusion

This document presented FirstRand's comments and recommendations on BCBS D355 – Standardised Measurement Approach for operational risk, issued by the Basel Committee on Banking Supervision (BCBS) in March 2016. Comments on individual paragraphs in the document were provided, as well as general comments on the proposed Standardised Measurement Approach (SMA). FirstRand's Operational Risk Management department can be contacted for more information.