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FRENCH BANKING FEDERATION DRAFT RESPONSE TO BASEL COMMITTEE ON REVISIONS TO THE STANDARDISED APPROACH FOR MEASURING OPERATIONAL RISK CAPITAL

The French Banking Federation (FBF) represents the interests of the banking industry in France. Its membership is composed of all credit institutions authorized as banks and doing business in France, i.e. more than 390 commercial, cooperative and mutual banks. FBF member banks have more than 38,000 permanent branches in France. They employ 370,000 people in France and around the world, and service 48 million customers.

General comments

The FBF welcomes the opportunity to comment the Consultation Paper on revisions to the standardised approach for measuring operational risk capital. We think that more consultation at an earlier stage would have been beneficial to all stakeholders.

We consider that the proposal submitted to consultation to the industry embeds evolutions that are highly questionable and do not reach the defined objectives of simplicity, comparability and risk sensitivity. Furthermore it comes up to a level of capital requirements that appear excessive and in many respects, redundant considering all the recent evolutions in capital requirements. We consider that the BCBS proposal could be improved without changing substantially the proposed approach.

Please find below our key messages and main propositions:

- One of the essential flaws of the current non AMA approaches is that it does not consider any incentives for an institution to improve its risk & control management framework. The revised Standardized approach (SA) should incorporate such a mechanism, through for instance a deduction from the Business Indicator (BI) of 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*. It should also clearly promote the use of more advanced approach that helps fostering enhanced risk management frameworks.

- The approach should rely on accounting data that are easy to get and not subject to significant differences among jurisdictions. It should furthermore deliver results that do not differ significantly from a local calculation to the other. We suggest that fees and commissions be considered for their netted amount.
- The relinquishment of any reference to business line is disputable. The former Basel business lines may be needlessly too numerous but they do reflect a reality. If we refer to AMA modelling, institutions come to the conclusions that wholesale banking businesses embed a higher degree of operational risk, and especially of unexpected losses, than retail banking ones. This could be reflected in the new approach through differentiated coefficients along three business lines: retail banking, wholesale banking and investment management. The approach appears far too progressive. It is highly disputable that small entities are exposed to low operational risks. Conversely, experience shows that in many times issues come from small and remote entities which cannot afford to develop a strong risk culture and framework. We suggest the layered approach to be simplified by reducing the number of buckets and far less progressive.
- It is not specified how the coefficient should be applied in cases of a group made of several legal entities and/or using mix approaches. We suggest the coefficient be applied at the level of the legal entities not withstanding intra group figures.

Answer to the questions

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

In existing standardized approaches for operational risk there is no established framework to review its calibration. This is recognized in the consultative document which states that "no rigorous review has been made of the effectiveness of the GI (or other potential indicators) as the proxy for the operational risk exposure of a bank and the adequacy of the calibration of the regulatory coefficients of the BIA and TSA". However, there is no information on what will be done to the revised method. It should be mentioned that the revised Standardised Approach would be subject to regular review (particularly of the coefficients).
Moreover, the current set of simple approaches doesn't takes into account the efforts that an institution makes in order to improve its risk & control management. As this is the case for the credit and market risk, the risk mitigation mechanism should be considered which is in the case of operational risk the control management framework. The revised approach should embed an incentive for institutions that dedicate human and IT resources to enhance this framework. In order to be as objective as possible, this could be done by considering the budget allocated to implement the second line of defense function dedicated to operational risk matters such as Corporate Operational Risk Management Function (CORMF) and Compliance.

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

The OpCaR and the single standardised approach are overly simplistic. The proposed method is based on historical averages of incomes and expenses and doesn't take into account forward looking considerations for instance the impact of all the rules actually defined (Volcker rules, French law of banking structural reform, …). Furthermore, it may be unstable through time and doesn't meet the objectives of simplicity, comparability and risk sensitivity (see Q3, Q4 and Q7).

Moreover, we do not agree with the statement that the business lines do not differ significantly in terms of operational risk profile. An overwhelming part of the large loss events of the recent years are linked with wholesale banking activities (subprimes, rogue trading, market rigging, embargoes, Madoff). Getting rid of any differentiation per business line appears too radical. However, we agree that it is appropriate to simplify the current Basel business lines classification. A proposal could be to differentiate only retail banking, wholesale banking and investment management.

Q3. Are there any further improvements to the BI that should be considered by the Committee?

The proposed approach does not appear to meet the objectives of simplicity, comparability and risk sensitivity.

Simplicity

The Business Indicator is not as easy to calculate as it seems to be. As such it raises numerous problems of implementation.

Some items composing the Business Indicator should be more explicitly defined such as operating expense and income. The guiding principles should be that information should be directly available in financial statements, without any specific accounting treatments or adjustments.

Furthermore, the BI is largely legal entity oriented when large institutions are more run along business lines. Management control statements do not convey the level of information required by this new indicator, making it extremely difficult to compute at a business line monitoring level and consequently to comply with the use test principle.
At last, implementing this new approach raise numerous operational issues such as the high level of granularity regarding information requested and the heterogeneity of local accounting translation of similar entries.

Comparability

Given the complexity of the BI definition, it is even more sensitive than the gross income indicator to difference in accounting rules between geographies or business lines, creating an undue uneven playing field.

This is especially true for the service component where rules regarding the accounting of fees, commissions, other operating incomes and other operating expenses are very much linked with local accounting standards. For instance, the legal entities mainly dedicated to leasing activities suffer from a huge and undue increase in their operational risk capital requirements. In order to smooth these accounting discrepancies, the Basel Committee should build the service component as a net basis rather than a sum of absolute values.

Comparability should also be ensured across time. We identify many elements that may induce significant swings in the level of capital, without these variations reflecting a relevant evolution of the risk profile of the institution:

- High sensitivity to the net interest margin
- Dependencies on actual amounts of operational risk which raise an issue when an institution suffers a large loss event. For instance, large fines make the standard capital charge jump upward and then jump downward when this event gets out of the time window used for the standard measure calculation.

<u>Risk sensitivity</u>

The approach is leading to counterintuitive allocation or variation (see the point just mentioned) of capital requirements regarding the operational risk profile of an institution.

We noticed that operational risk capital requirement for Retail Banking activities will significantly rise when the Wholesales banking one will relatively decrease. Once again, an overwhelming part of the large loss events of the recent years are linked with wholesale banking activities (subprimes, rogue trading, market rigging, embargoes, Madoff). The new approach, as it is now, may drive misleading management decisions.

Another illustration can be given with the high dependency of the BI on the service component and the absolute value calculation method. For instance a service business that operates through intermediaries (B to B) will be required a very high level of capital (high fees incomes and fees expenses) without it being properly justified by historical data.

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

The calibration of the coefficients including OpCar modelling raises several major issues especially regarding 10 years of experience in OR capital requirement modelling.

We may still express few remarks on the OpCaR:

- The population on which OpCaR is calibrated seems hardly representative (99 about 270, 33%). The paper doesn't give any indication on the main feature of the final sample. Maybe this information is contained in the Group1/Group2 distinction mentioned page 23 &36 but it isn't explained in the consultative paper.
- The initial choice to base all the computation on aggregated losses with a single distribution approach is questionable with regard to 8 years of AMA practice.
- The over representation of Pareto distribution is amazing given the proportion of case where mean can be infinite when in the same time all the forms of sub-exponential distribution have not be retained.
- The filters applied to select ranges are neither explained nor justified.
- The final results obtained through the selection process seem quite few and could have been back tested.

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?

We consider that the exposition to operational risk is not only a matter of size. Experience demonstrates that small, and often remote, entity may be exposed to a significant level of operational risk, possibly without comparison to their size. Furthermore, small entities belonging to a large group can rely on a stronger and mutualized framework than the same entity on a stand-alone basis. For instance, where a legal entity seem to be fragile common regulatory recommendations is to foster reliance on a larger group.

Getting rid of any differentiation per business line and relying only on size appear too radical. We consider the proposed approach should be reviewed in order to be far less progressive with buckets differentiated per business line. Furthermore, this would be consistent with the rating agencies requests and ways of assessing risks. However, we agree that it is appropriate to simplify the current Basel business lines classification. A proposal could be to differentiate only retail banking, wholesale banking and investment management.

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

As previously mentioned, the new approach should consider a mechanism that would incentivize institutions to operate a high standard risk & control framework. We suggest that institutions may deduct from the BI expenses supported to run their second line of defense focused on what the capital requirement intends to cover: that is operational and non-compliance risk, i.e. the Operational Risk function and the Compliance function. Doing so, resources in independent control management and expenses in term of IT tools will be properly taken into account.

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

A doubt persists on the application of this method in a bank with a subsidiarised model. Should the regulatory capital requirement be computed:

1. From bottom to top: the group capital requirement will be the sum of the capital requirements at the subsidiary level
2. From top to bottom: the calculation will be made at a consolidated level and then an average alpha will be apply to every entity
3. At the group level using group Business Indicator and corresponding coefficient and at legal entities level for the local one making it impossible to reconcile both view?

The last two solutions have significant flaws. The second one is simple to implement but creates a counter intuitive uneven playing field between competing entities given the size of the group they rely on (the larger the group, the more capitalized they need to be). The third one appears to be very difficult to manage operationally from a use test perspective with two unreconciliable views and the paradoxical output where the entities that cannot rely on a large group require a much lower level of capital.

In the case of a banking group, intragroup transactions should be excluded from the BI calculation for each individual legal entity.

Some guidance would also be needed for institutions applying a hybrid approach, i.e. having the bulk of its entities under the AMA and the remaining part under a simpler approach.

We suggest the coefficient be applied at the level of the legal entities not withstanding intra group figures.

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

It is obvious that banks with high interest margin such as the top-tier banks will be highly penalized with this model irrespective of the quality of their operational risk management. The use of a threshold could be a solution but needs to be more explicit.
Moreover, the absolute value in the Business Indicator calculation and the gross of the coefficient is also emphasizing this issue.
Even in case of low interest margin, the NIM indicator includes cost of funding/liquidity spread and average quality of the portfolio (average credit rating of the clients for lending). It is then not a pure operational risk indicator.
On top of that, absolute level of NIM is correlated with the absolute level of interest rate. Then BI is still sensitive to absolute level of interest rate and thus procyclical.
Impact of this new approach on high fees businesses should still be qualified.

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

Any capital methodology should foster better risk management within the institutions concerned. The document under consultation does not reach this important objective.

First of all the proposed revision should not create any discrepancies between risk measurement and risk management objectives which is not the case currently (see Q3).

It should also emphasize and foster the use of AMA as a key driver for better understanding and managing the risk profile of an institution and its internal control framework.

It should then in the Simplified Approach take into account investments made on the improvement of the operational risk management. One of the lessons from the Review of the Principles for the Sound Management of Operational Risk is that the “risk identification and assessment tools (principle 6) have not been fully implemented because they were not deemed necessary for risk measurement purposes”.

Taking into consideration investments on IT and human resources should be explicitly considered in the BI indicators, for instance through a deduction from the BI of the amounts spent under the authority of a second line of defense control function.
(See answers to Q1 and Q6).