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Consultative Document on Standardised Measurement Approach for Operational Risk (BCBS 355)

3 June 2016

Enclosure

Comments of the German Banking Industry Committee

Dear Sir, Madam,

Thank you for the opportunity to comment on the Consultative Document on Standardised Measurement Approach for Operational Risk (BCBS 355). Please find enclosed the comments of the German Banking Industry Committee.

Yours sincerely,
on behalf of the German Banking Industry Committee,
Association of German Banks

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German Banking Industry Committee

Die Deutsche Kreditwirtschaft

Comments

on Consultative Document on Standardised Measurement Approach for Operational Risk (BCBS 355)

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Berlin, 2 June 2016

The **German Banking Industry Committee** is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks finance group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent approximately 1,700 banks.

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Key messages in brief

- In autumn 2015, the BCBS announced that it would withdraw the AMA for operational risk. It stated that the rationale for dropping the AMA would be explained in the BCBS's new consultative document. In our view, however, the consultative document does not make a persuasive case, backed up by data, to justify the withdrawal of the AMA. We therefore call on the BCBS to expand on the reasons for its decision (see page 4).

- We estimate that capital requirements will rise particularly sharply for comparatively large banks and, above all, banks which are currently permitted to use the AMA but which will in future be obliged to use the SMA. As a result of the modified calculation methodology, capital requirements will also rise for some smaller banks. We therefore consider it essential to have adequate and credible transitional arrangements in place for the changeover to the SMA, accompanied by a phase in of capital requirements and recalibration of the BI in the higher buckets (bucket 3 upwards) and of the ILM. It should also be made possible to terminate the use of the AMA immediately on the introduction of the SMA in order to avoid unclear risk management impulses (see page 5).

- Capital requirements calculated using the SMA consider only information about the past, both in the BI and in the ILM. As a result, the present design of the loss component is loss sensitive rather than risk sensitive. Steps taken by management to reduce the bank's operational risk are not directly taken into account. We believe this approach needs to be modified so that banks still have an incentive in pillar 1 to practise active risk management. This incentive should primarily be reflected in the ILM and would have a positive impact on the risk sensitivity of the SMA (for details, see pages 6 and 9).

- The consultative document is vague on the question of which loss data are to be used in the SMA. We would appreciate clarification that net losses, i.e. losses after taking into account direct recoveries, are to be used in the SMA loss data set (see page 8).

- Taking account of loss data on the basis of a ten-year history will, it is true, smooth out fluctuations in loss components to a certain extent. Nevertheless, the SMA in its present form may lead to sharp rises and falls in capital requirements for operational risk from one year to the next (cliff effects), especially since high losses are given a higher weighting in the calculation of the loss component (multiple counting) and then have a consistently strong impact over the entire ten-year period. We would recommend lowering the weighting of higher losses in general, reducing the weighting of losses over time and using a continuous loss event band structure to calculate the loss component (see page 10).

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General comments

On 4 March 2016, the Basel Committee on Banking Supervision (BCBS) issued a consultative document on the Standardised Measurement Approach (SMA) for operational risk. The basis for calculating capital requirements is – as proposed in the first consultative document of October 2014 – the Business Indicator (BI), though now in a somewhat modified form. The calculation method has been supplemented by the Internal Loss Multiplier (ILM), which we warmly welcome. The main purpose of the ILM is to increase the risk sensitivity of the approach. Once the SMA is introduced, all current standardised approaches, along with the Advanced Measurement Approach (AMA), will be withdrawn. The objective is to simplify the framework for calculating capital requirements and improve comparability across banks. The BCBS has stated that it aims to not significantly increase overall capital requirements.

The German Banking Industry Committee (GBIC) warmly welcomes the proposed adjustments to the method of calculating the BI (net approach to the treatment of leases, maximum approach for calculating the services component, adjustment factors for certain types of business model). These adjustments will ensure that economically equivalent transactions with an identical level of risk are given the same treatment when calculating capital requirements. We also welcome the recalibration of the BI buckets, with the increase in the upper threshold of bucket 1 to €1bn and a finer breakdown in the higher BIs.

Withdrawal of the AMA

In autumn 2015, the BCBS announced that it planned to withdraw the AMA for operational risk. It was stated that the rationale for dropping the AMA would be explained in the BCBS's new consultative document. In our view, however, the consultative document does not make a persuasive case, backed up by data, to justify the withdrawal of the AMA. We therefore call on the BCBS to expand on the reasons for its decision.

Whilst we understand the argument of wishing to reduce the variability of RWA calculations, it is undeniable that the AMA has improved banks' understanding of operational risk and encouraged banks to improve the availability and quality of internal and external data. The withdrawal would come at a time when new research results on the modelling of operational risk are appearing almost daily. A true opportunity may thus be missed to narrow down practices, possibly with the assistance of supervisory guidance.

Moreover, banks' experience with AMA-type models used for ICAAP purposes provides clear evidence that it is precisely a reduction of the risk profile to one or two established risk measures which triggers active challenge in institutions, firstly of the data, secondly of the underlying processes, and thirdly of operational risk itself. It will be impossible to disseminate such models when supervisors clearly signal to the banks that they do not trust them by withdrawing the AMA.

Furthermore the SMA may set unintended incentives with regard to banks' risk management activities. Institutions may be tempted to manage their accounting positions – the basis for measuring operational risk in the SMA – instead of managing the risk itself. Changes in accounting would have an immediate effect on operational risk capital. Additionally, withdrawing internal models from pillar 1 creates no incentive to use internal models under pillar 2, despite their proven effectiveness as management tools.

Increase in capital requirements

We estimate that capital requirements will rise particularly sharply for comparatively large banks and, above all, banks which are currently permitted to use the AMA but which will in future be obliged to use the SMA. As a result of the modified calculation methodology, capital requirements will also rise for some smaller banks. We therefore consider it essential to have adequate transitional arrangements in place for the changeover to the SMA, accompanied by a phase in of capital requirements and recalibration of the BI in the higher buckets (bucket 3 upwards) and of the ILM.

Banks which currently have permission to use the AMA will inevitably find themselves in one of the higher buckets under the SMA. Their capital requirements will therefore rise. The Basel Committee's decision to withdraw the AMA should not, however, in itself lead to banks having to meet higher capital requirements from one day to the next. Research by some banks which will be assigned to buckets 2 and 3 indicates that they will also face an increase in capital requirements as a result of the new calculation methodology. To allow medium to long-term capital planning, all banks need to be granted a transitional period which allows them to implement the requirements progressively. However, It should also be an option to terminate the use of the AMA immediately on the introduction of the SMA in order to avoid unclear risk management impulses.

On top of that, the BCBS's proposals fly in the face of its objective of not significantly increasing overall capital requirements. Some supervisors have stated that the SMA has been calibrated in such a way that they anticipate an overall increase in capital requirements for operational risk of around 20%. Other surveys have concluded that most large banks will see their capital requirements for operational risk rise by around 50% on average. The impact of the higher capital requirements in the higher buckets (buckets 3 to 5) will therefore outweigh the capital relief in bucket 1, meaning that the increase in overall capital requirements will most certainly not be insignificant. In view of the fact that the Basel Committee is currently reviewing the measurement of capital requirements in other risk categories as well, the cumulative effect of all changes needs to be considered. For this reason, we would recommend recalibrating the risk weights in the higher buckets.

Objectives of the SMA – simplification and comparability

Introducing a single approach to calculating capital requirements for operational risk will certainly achieve the objective of simplification. As for comparability, we would ask the BCBS to provide further information about calculating the ILM.

The ILM is based on a bank's loss experience over the previous ten years (or less if good-quality loss data is not yet available for this period). In addition, banks have to apply general and specific criteria for the identification, collection and treatment of their loss data. A number of technical questions arise concerning the collection of loss data, and while these have the potential to compromise comparability, they are not addressed in the consultative document. The questions relate, for instance, to the timing of the inclusion of losses in the data set, and the method of calculating the amount of loss. The proposals in their present form give banks a significant amount of leeway, which will make comparisons more difficult, in our view, thus undermining the BCBS's objective.

Risk sensitivity of the SMA

Capital requirements calculated using the SMA consider only information about the past, both in the BI and in the ILM. As a result, the present design of the loss component is loss sensitive rather than risk sensitive. Steps taken by management to reduce the bank's operational risk are not directly taken into account. We believe this approach needs to be modified so that banks still have an incentive in pillar 1 to practise active risk management. This incentive should primarily be reflected in the ILM and would have a positive impact on the risk sensitivity of the SMA.

The planned withdrawal of the AMA makes it all the more important to retain an incentive to engage in active risk management. Banks currently using the AMA have been encouraged by their supervisors to incorporate forward-looking information into their calculations of capital requirements. For banks which have invested heavily in processing forward-looking information, a return to considering past data only would represent a serious setback. Managerial measures which clearly have the potential to reduce operational risk must have a place in the calculation of capital requirements.

We therefore consider it essential, when further developing the SMA, to focus on increasing the risk sensitivity of the approach. To this end, the consultative document should provide clear guidance on examining the relevance of loss data in the loss component. In our view, a bank's risk profile would be more appropriately reflected in the loss component if irrelevant data could be removed from the data pool. If, for instance, it is possible to identify a direct correlation between a specific measure implemented by management in response to a specific loss event and if it can be demonstrated after a certain amount of time has elapsed that, as a result of this measure, no further losses have been incurred, the corresponding loss data should be removed from the data pool.

Detailed comments

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

Accounting basis

The BI is determined on the basis of various P&L and balance sheet items. The consultative document does not specify whether local or international accounting standards are to be used at single entity level or at various levels of consolidation. We would suggest allowing banks themselves to decide.

The reason is that this solution would avoid unnecessary administrative work when calculating the BI. Using accounting standards other than those usually applied at single entity level or one of the various levels of consolidation would require banks to invest considerable financial and time resources when switching to the SMA. We therefore believe that, at single entity level, the bank should be able to choose whether to calculate capital requirements on the basis of international accounting standards or national GAAP. We would welcome it if, in addition, banks could choose whether to use the accounting or regulatory scope of consolidation to calculate their BI.

Definition of operating lease income/expenses

In the interest, lease and dividend component (ILDC), income and expenses from operating leases are described in Annex 1 as "interest income from operating leases" and "interest expenses from operating leases". These items do not actually exist in the context of operating leasing. The descriptions ought to read "income from operating leases" and "expenses from operating leases". We would ask for the wording to be amended.

Income and expenses from service contracts associated with leases

Income and expenses from service contracts concluded in connection with leases have not yet been assigned to the item "financial and operating lease income" and "financial and operating lease expenses". We would suggest adding the income and expenses from such contracts to the list of exemptions in para 46.

Lessees are able to purchase certain services associated with the lease they have concluded. These include maintenance services performed by authorised garages, such as inspections or changes from winter to summer tyres and vice versa. But a service contract concluded in connection with a car lease, for example, may also include times such as the collection of motor vehicle tax or radio licence fees. Services like these are neither banking services, near-bank services, financial services nor ancillary banking services. If the services were provided by a straightforward service provider, they would not have to be included in the regulatory scope of consolidation and would not be subject to capital requirements. For this reason, they should also be excluded from the calculation of the BI. An item along the following lines should be added to the list of exemptions in para 46:

"Income and expenses from services, such as maintenance services or the collection of taxes for the leased assets, which are rendered in connection with leases or alone and are neither banking nor near-banking activities, nor financial services nor services that are necessary to perform banking activities."

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An alternative – and practical – solution would be to include the income and expenses from such service agreements (forming part of a full service lease, for example) in the existing netting approach for the treatment of leases. An argument in favour of this approach is that the income and expenses from these services are already contained in the net income from leasing, making it very easy to calculate the BI.

List of exempted items

Para 46 lists items which should not be included in the calculation of the BI. To avoid the calculation generating an excessive workload, we believe the exclusion of these items should be optional if the result is merely that the bank will have a less favourable BI.

Banks should be permitted to include exempt items in their calculations because it will sometimes be extremely difficult and time-consuming to filter out some of the items on the list. The biggest items will generally be administrative expenses and provisions. It will normally be comparatively easy to exclude these items when calculating the BI. Other items, by contrast, are more difficult to exclude because these are made up of entries at individual account level. Since banks will put themselves in a less favourable position by including items on the list, no additional risk will be generated. For this reason, we believe it would be appropriate to give banks the option of including the listed items in their calculations.

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?

ILM for banks in bucket 1

We very much welcome the inclusion of a loss multiplier in the SMA, especially in the event that the AMA is withdrawn. We do not agree, however, with its use only by banks in buckets 2 to 5. We feel that this is discriminatory against bucket-1 institutions and will create an unlevel playing field to the disadvantage of small banks. We would ask the Basel Committee to allow small institutions to apply the ILM on a voluntary basis or on application to their supervisors. More specifically, we would suggest applying the loss multiplier to half of the business indicator of bucket-1 banks provided that they can demonstrate to the satisfaction of their supervisors that their loss data collection meets the standards set out in the consultative document.

Loss data

The consultative document is vague on the question of which loss data are to be used in the SMA. We would appreciate clarification that net losses, i.e. losses after taking into account direct recoveries, are to be used in the SMA loss data set.

Gross loss and net loss are defined in section 6.2. This section also requires banks to be able to identify separately gross loss amounts, non-insurance recoveries and insurance recoveries. Finally, it is specified that losses before the deduction of insurance recoveries should be used as input into the SMA loss data set. It is not entirely clear, in our view, on which data the SMA is supposed to be based. Banks currently applying the AMA, use losses <u>net</u> of direct recoveries as loss data. In the interests of consistency with current practices, losses net of direct recoveries should also be used in the SMA.

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Any other approach, such as the use of gross losses, might have unforeseen consequences. Take payment transactions, for example. Processing errors, which are normally swiftly rectified, would have to be included in the SMA loss data set although no real loss event had actually occurred. The use of gross losses would discriminate against the payments unit and, in addition, overstate the risk.

All in all, our understanding of the consultative document is that the basis of the SMA loss data set should be net loss, meaning loss after taking account of direct recoveries (before deduction of insurance recoveries and other risk transfer measures).

Relevance of data in the loss component

The Basel Committee proposes that loss data going back ten years should be used for calculating the loss component. The consultative document does not, by contrast, explain how to handle data relating to losses which were incurred as a result of certain activities in the past but which can no longer be incurred in the future because the bank has modified its business strategy or introduced certain risk management measures. We would recommend that the BCBS should provide for the ability to adjust data histories in such cases.

In the course of a regular business strategy review, a decision may be made to adjust the bank's strategic direction. Such decisions are made after weighing earnings potential and risk. As a result, banks and banking groups are constantly making adjustments to aspects of their business such as the product range, involvement in certain countries or the sale of subsidiaries or business units. Certain loss data lose their relevance to the bank's risk profile in the process. To better reflect risk profiles and increase the risk sensitivity of the SMA, we would suggest permitting banks to remove from the data set loss data which are no longer relevant and add data which have become relevant. The reasons for modifying the data could include:

- the withdrawal of certain products
- the end of the bank's involvement in certain countries
- the sale of subsidiaries or business units
- improvements to processes as a result of which a loss event cannot reoccur.

This would increase the incentive to engage in active risk management and ensure that measures which reduced operational risk were reflected in the calculation of the loss component. To ascertain that measures were actually implemented and had a positive impact, they could be reviewed by an auditor.

Counting and distributing losses

The specific criteria in section 6.2 require banks to have a policy setting out criteria for determining when a loss should be included in the loss data set for the calculation of capital requirements under the SMA. We see a need to flesh out the criteria for counting and distributing losses in more detail.

The full extent of a loss incurred as a result of an operational risk event is frequently not identified at any particular point in time. The amount of the loss may change over time. The question arises as to how such changes should be handled when using the SMA. One option would be to count an increase in the loss amount in the year in which the bank becomes aware of the increase. In the interests of consistency in the calculation of capital requirements, the BCBS should include guidance on how to deal with such cases when determining the loss component.

Cliff effects and high volatility

Taking account of loss data on the basis of a ten-year history will, it is true, smooth out fluctuations in loss components to a certain extent. Nevertheless, the SMA in its present form may lead to sharp rises and falls in capital requirements for operational risk from one year to the next (cliff effects), especially since high losses are given a higher weighting in the calculation of the loss component (multiple counting) and then have a consistently strong impact over the entire ten-year period. We would recommend lowering the weighting of higher losses in general, reducing the weighting of losses over time and using a continuous loss event band structure to calculate the loss component.

We appreciate that the intention is for banks with different loss distributions but the same average loss totals to be subject to different capital requirements. The BCBS proposes achieving this by multiple counting of higher losses in the loss component. The consultative document does not make it clear what data have been used to arrive at the calibration of the loss component. This goes both for the level of the thresholds used in the computation (€10 million and €100 million) and for the proposed multipliers (7, 7 and 5). A 19-fold consideration of loss events exceeding €100 million seems excessive and unreasonable. The result will be to generate a degree of volatility both when the event first enters the data pool and at the end of the ten-year period which does not reflect the bank’s risk profile. It would be helpful, in our view, to introduce an additional threshold of €1bn. But we urge the Basel Committee to revisit the overall calibration of the loss component, especially when it comes to the treatment of higher losses.

A further point needs to be borne in mind. High loss data will have a significant impact on capital requirements over a very long period. Steps taken by management to prevent a recurrence of the loss will not be taken into account. To keep the impact of high loss data within reasonable limits, earlier losses could be assigned a lower weighting. If a loss event occurred six or more years previously and no further losses in this connection have been identified since then (as a result of measures introduced by management, for example), it should be possible to reduce the weighting.

The loss component distinguishes between loss events above €10 million and €100 million. An increase in provisions, for example, may lead to reclassification to another loss event band and therefore the application of another multiplier. If, for instance, a provision of €99 million (band 2) is increased by €5 million, the new amount of €104 million will also fall into band 3 (above €100 million) as things stand. We believe it would be more appropriate to include only the amount exceeding the €10 million or €100 million threshold in the higher band, not the total loss amount. In the example above, this would be €4 million. We would recommend taking this into account during the calibration. We would welcome a continuous band structure – along the lines of that proposed for the BI components.

Reference date

Under para 43, it will be mandatory for banks to collect the date of accounting of an operational risk event. We would suggest making the collection of this information voluntary, or requiring it only when it makes good sense to do so.

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We do not see how collecting the date of accounting will facilitate the management and monitoring of loss events. On the contrary, we fear it will lead to unnecessary complications and errors. Provisions, for instance, are frequently not recognised immediately, but only entered into the accounts at the end of a quarter or business year. The bank will nevertheless already be aware of the event and will normally have already entered it into the loss database. Sometimes, moreover, there is no specific date of recognition in P&L. Time sheet fraud perpetrated over a lengthy period would present a problem in this regard, for example. Legal disputes also normally involve several accounting entries – which one would be relevant? Making it mandatory to input the date of accounting would consequently give rise to numerous problems, while the associated benefit seems uncertain. We therefore consider the mandatory collection of the date of accounting impracticable.

Consolidation

The regulatory scope of consolidation is used for the purposes of calculating the BI. Calculation of the Loss Component is based on internal loss data, which is collected under Pillar II on the basis of an economic approach, e.g. materiality for risk management purposes. The consideration of entities differs regarding regulatory and Pillar II consolidation. On the one hand entities may be considered under Pillar II for loss data collection, which are not relevant for regulatory consolidation. On the other hand loss data may not be collected under Pillar II for entities, which are relevant for regulatory consolidation. Among these can be cases where loss data collection is not possible or there is no legal obligation for loss data collection.

These differences may result in inconsistencies between the two elements of the SMA as well as additional efforts and costs. We therefore propose to allow institutions to adjust the scope of loss data collection by eliminating losses of entities which are not relevant for regulatory consolidation and make an add-on for material (a materiality threshold should be defined) entities which are not relevant under Pillar II.

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?