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Die Deutsche Kreditwirtschaft

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Comments by the German Banking Industry Committee on the Consultative Document "Operational Risk – Revisions to the simpler approaches" (BCBS 291)

5. January 2015

Annexes

Dear Madam, dear Sir,

First of all, we would like to express our thanks for giving us the opportunity to comment on the consultative document indicated above. We welcome this opportunity, and would like to make the following statements:

General Statements

On 6 October 2014, the Basel Committee on Banking Supervision published a consultative document proposing to replace the existing three Standardised Approaches (BIA, TSA, ASA) by a single new Standardised Approach. One of the reasons for the revision carried out by the Basel Committee was the fact that capital requirements for operational risk had proven inadequate in the wake of the financial crisis. According to the analyses carried out by the Committee, this applied in particular to larger and more complex banks.

Whilst we understand the intentions of the Basel Committee, with regard to increasing capital requirements for operational risk, we would like to point out that the level of risk an institution is exposed to usually depends on the products, business activities and the legal framework of the respective bank. We can no longer reconcile this relationship in the proposed revised Standardised Approach – or the approach implies that such a relationship does not exist.

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From our perspective, sample calculations used as the basis for the new Standardised Approach clearly indicated that for a large number of institutions, the capital requirements for operational risk will increase dramatically. Moreover, this will not only affect larger or more complex institutions. In particular, the higher capital requirements will affect business models which are not exposed to increased operational risk at all, as well as specialist institutions and banks with specific sales channels – which are not comparable to universal banks. Some institutions with leasing business will face an increase in capital requirements for operational risk by a factor of ten. As far as we are aware, such an effect would not be in line with the intentions of the Basel Committee at all. Therefore, we consider it necessary to adjust the new Standardised Approach.

For the reasons listed above, we propose an economic approach for the calculation of the Business Indicator (BI): according to the consultative document, institutions whose business focus is outside lending will have to report income and expenses mainly in the services component. The services component, however, is a gross position – where the respective income and expense items are aggregated. As a result, institutions offering services and operating sales channels outside the lending business will be put at a disadvantage, in terms of determining operational risk, compared to banks whose main activity is in lending. In particular, this is inconceivable if the services rendered are comparable to the lending business from an economic perspective (such as the leasing business – see question no. 8). For this reason, we propose to include "economically similar income and expenses" in the interest component. This would also allow the inclusion of income and expenses attributable to other major business lines. These items would then be calculated on a net basis, avoiding the discrimination of individual business lines. The type of the institution involved could be taken into account for determining whether such economically similar services exist. In the case of custodian banks, securities trading banks or transaction banks, as well as home loan savings banks, the income and expenses generated in the major business lines could be included in line with the interest component. A relative criterion might be added as well: if the income from an individual business line exceeds a predefined share of an institution's total income, the income and expenses from that business line should be calculated on a net basis.

Questions

Question 1

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

Going forward, it would make sense to analyze loss data on operational losses for the lending and the leasing business separately, in order to facilitate a comparison of loss characteristics in the lending and leasing business.

Question 2

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

From our perspective, it is conceivable to achieve at least the objective of simplicity with a single Standardised Approach. However, the adjustments described above would be necessary to avoid a discrimination that is unjustified on the basis of the actual risk exposure. When carrying out empirical reviews, special attention should be given to banks causing spikes.
In order to fulfil the objective of comparability, we believe that the adjustments listed under "General Statements" above will have to be taken into account. Transactions which are economically identical and represent the same level of risk should be treated equally in the calculation and determination of capital requirements. Therefore, we believe it is appropriate to consider the economic approach.
Another aspect of the comparability objective is a consistent interpretation of the positions included in the Business Indicator, we believe. According to the consultative document, calculation of the Indicator's positions is based on the income statement. From our perspective, this creates two challenges: on the one side, national GAAPs differ, creating leeway for interpretation regarding the positions to be included. On the other side, calculating capital requirements on the basis of accounting regulations may lead to different results where accounting options are used, despite an identical level of risk. To enhance comparability, we recommend not to use accounting regulations, but the economic background as criteria for consideration in the respective component.

From our perspective, it would be difficult to achieve some sort of risk sensitivity using only one approach if the other objectives are to be achieved simultaneously.

Question 3

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

Annex I includes a list of "typical sub-items". The designation is not always unambiguous or clear enough, from our perspective. For instance, what items should be included under "gains from non-recurrent assets and disposal group classified as held for sale not qualifying as discontinued operations"? Why do the positions "income from financial leasing and operating leasing" and "expenses for financial leasing and operating leasing" form part of other operating income and expenses? From our understanding, these

items are shown separately on the income statement as soon as a certain level of relevance is achieved. This in turn would be an argument not to include income and expenses from leasing agreements in the services component, but to classify it in line with interest income and expenses. Hence, we kindly request that the document be amended and clarified accordingly.

In addition, we raise the question as to how the calculation of interest income and expenses – as well as income and expenses from leasing agreements – shall be done, after an effective and material risk transfer of securitisation positions has been effected in accordance with supervisory requirements, but the securitised receivables remain on the balance sheet due to differing objectives in accounting regulations. Against the background of the effective risk transfer, we recommend that the interest result – as well as income and expenses from leasing agreements resulting from such receivables – may be excluded from the calculation of the Business Indicator in such cases; we request that the document be clarified accordingly. This would be appropriate given the fact that the servicing fee charged for the management of receivables is supposed to increase the Business Indicator. In all other cases, these positions would be recognised twice, without justification.

Extraordinary and irregular income is excluded from the calculation of the indicator, according to current regulations. The proposed consultative document does not provide guidance regarding the recognition of extraordinary or irregular income and expenses in the calculation of the Business Indicator. We kindly ask for a clarification in the document that such items may still be excluded from the calculation going forward, and that the existing common approach prevails.

Question 4

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

Whilst the theoretical approach regarding the statistical analysis – including statistical formulae – is explained in detail, the Basel Committee chose not to publish the empirical results. However, we believe the empirical results are necessary to be able to reconcile the Committee's conclusions. We therefore kindly ask that these results be published after the final calibration has been undertaken based on the results of the last QIS.

The Basel Committee should assess the impact of the new Standardised Approach, both upon universal banks and specialist banks, on the basis of a peer group comparison before the final calibration. We believe this is necessary, especially in view of the construction of the Business Indicator. Conceptual errors in the design of the Business Indicator's components could be overseen if the number of companies affected is small or if the error has no material consequences on the static analysis because the affected income and expense positions of the sample companies represent only a minor fraction of total business volume. For companies outside the sample, this may result in a dramatic increase in capital requirements. For this reason, loss data on operational losses for the leasing business should be compared to loss data for the lending business.

Question 5

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?

The consultation paper does not provide information on how the proposed size-based buckets and coefficients were derived, which hampers further considerations. We kindly ask the Basel Committee to provide the necessary transparency, in order to allow concrete statements.
When calibrating the size-based buckets and coefficients, the Basel Committee should be aware of the fact that the Business Indicator itself leads to an increase of capital requirements for operational risk. Another increase will be achieved by applying a higher weighting factor (compared to the current 15%) on higher buckets. We reject this "double" increase in capital backing requirements, as insufficient reasoning is provided from our perspective. We understand that larger banks had to bear higher losses in the past. However, it is not conceivable to us how this risk level corresponds to an additional weighting factor of 30%.

Moreover, we consider the ">3.000 - 30.000" bucket as too large, since medium-sized companies would also fall into this bucket, with excessive burdens as a consequence. Thus, we would welcome a further refinement with a lower coefficient.

Question 7

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

Referring to the calculation of capital requirements for operational risk at group level, it should be clarified that the coefficient may be calculated on the basis of the Business Indicator at individual bank level – and then be included in the consolidation, with the applicable capital requirement.

Question 8

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?

From our perspective, the Basel Committee should concentrate on institutions highly specialised in fee business and other specialist institutions, as well as the leasing business. In this context, we have provided three examples (non-exhaustive list) in the Annex to this document, showcasing how the Committee's proposed regulations would lead to extensive surplus loads, although the transactions provided do not involve higher operational risk. The examples provided refer to the following subjects:

1. Institutions conducting leasing business
   When taking a lease into account in the income statement this generally involves income and expense items which need to be considered together, from an economic perspective. Incorporating such transactions in the service component (and thus on a gross basis) does not adequately reflect the

economic substance of such transactions. In contrast, such leases are very similar to lending, with similar operational risks involved. For this reason, we propose to take the leasing business into account on a net basis, and in conjunction with the interest component.

Moreover, the Basel Committee should bear in mind that there are no harmonised global criteria in place concerning the assignment of beneficial ownership. As a result, the classification of transactions as financial or operating leases may differ from country to country, or by reference to a different accounting framework. Depending on such classification, capital requirements would differ even though operational risk exposure would not. Hence it is inappropriate to link the determination of the Business Indicator for leases to the accounting treatment alone.

In fact, the proposals put forward by the Basel Committee would have a substantial impact upon institutions active in the leasing business. Sample calculations have indicated that the proposed rules would raise capital charges for leasing business to as much as twenty times the requirements for lending business – the capital requirements for operational risk would be eight times the existing requirements. Total capital requirements for institutions conducting leasing business would double in some cases. Given the discrimination of leasing business vis-à-vis traditional lending, this would give rise to pronounced crowding-out and substitution effects – in effect representing a structural policy measure.

Please refer to example 1 in the Annex for a more detailed presentation of the factual background.

2. <u>Fees and specialist institutions</u>

a) *Institutions with a special distribution channel*

An institution has structured its business model in a manner such that its own financial products are distributed through a network of third-party distribution partners. In this context, income is recognised from fees received whilst expenses are recognised for pro-rata commissions paid to distribution partners ('pass-through' items). Income and expenses are related to one and the same transaction, which is why inclusion on a gross basis would lead to a 'dual' capital requirement.

Please refer to example 2 in the Annex for a more detailed presentation of the factual background.

b) *Institutions offering a single customer product*

A subsidiary of a financial conglomerate distributes one product only, generating income from interest margin and a portfolio-based commission paid on a regular basis. The capital requirement for this entity would rise threefold.

Please refer to example 3 in the Annex for a more detailed presentation of the factual background.

Besides the economic analysis (refer to the General Comments), the inclusion of transactions to be classified under the service component should also be adjusted. The service component provides for the inclusion of commission income and expenses as well as other operating income and expenses, on a gross basis. In this connection, we see a risk that such gross analysis exaggerates an institution's operational risk exposure – especially where a transaction gives rise to both income and expenses. However, this will not necessarily involve a higher level of operational risk simply because both sides of the income statement are involved. A transaction that only generates income will not be exposed to higher or lower operational risk. In fact, institutions incurring expenses due to having taken risk-mitigating measures

would face a dual penalty. We therefore propose the following adjustment to determining the service component:

> *Service component = max (fee income; fee expenses) + max (other operating income; other operating expenses)*

Given the intention of structuring the Standardised Approach as simply as possible, we propose to introduce a maximum consideration: the service component should provide for the higher absolute amount of commission income and expenses, and for the higher absolute amount of other operating income and expenses. This would prevent dual inclusion of transactions involving income and expenses. If income were to be included in the service component, any expenses for risk-mitigating measures would not increase the indicator. Conversely, if expenses were to be included, risk-mitigating expenditure would serve as a proxy for the underlying transaction. Moreover, this approach would ensure that declining income would not automatically reduce capital requirements – an effect which the Basel Committee has criticised in the context of using gross income as an indicator.

Additional Statements

We welcome the Basel Committee's decision to publish the methodology for deriving the calibration of the new Standardised Approach. Nonetheless, we would like to take the opportunity to comment on some weak points within the methodology. We hope to provide useful input for future calibrations.

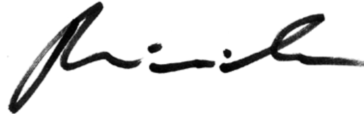
- From our perspective, the appropriateness of the OpCaR, which represents the major risk indicator in the calibration of the Standardised Approach, has not been sufficiently demonstrated. In order to achieve conformity with common minimum requirements for loss distribution approaches (LDA), the OpCaR should include – to the greatest extent possible – the data of all banks involved for the stabilisation of the severity distributions of losses in the tail section. For this purpose, data input of AMA (Advanced Measurement Approach) banks should be used as well.
- Of course, the functions to be matched are inappropriate functions – an optimal solution still needs to be found. We were not able to proof linear correlations between the indicators analysed and the OpRisks forecasted or calculated based on the OpCaR model. It is questionable if the non-linear connections identified can be explained objectively or if they result from pure accident. Therefore we think the OpCAR methodology has too high a bias to be used in appropriately estimating operational risk. Instead, we recommend replacing the OpCaR with more established approaches , e.g. LDA—type procedures, to be further developed and validated statistically, taking into account the losses of all banks involved in different sections.
- The exclusive use of a single proxy (no matter which proxy) for the assessment of operational risk is not reasonable from our perspective. This leads to the negligence of other risk factors, such as complexity of products or number/effectiveness of risk processes implemented. These items, or comparable criteria, should at least be considered, as an optionality, in the coefficient.

The consultative document does not provide a time schedule for the implementation of the proposed regulations. We kindly request provision of such a schedule. Moreover, we recommend the simultaneous implementation of the new Standardised Approach for operational risk with the planned Standardised Approaches for credit risk and market risk.

We respectfully request that our statements be taken into consideration.

Yours sincerely,
on behalf of the German Banking Industry Committee
Bundesverband der Deutschen
Volksbanken und Raiffeisenbanken e.V.

by proxy



Gerhard Hofmann Thorsten Reinicke

Annex

Comments by the German Banking Industry Committee on the Consultative Document "Operational Risk – Revisions to the simpler approaches" (BCBS 291)

<u>Example 1 – Institutions conducting leasing business</u>

According to Annex 1, all income and expense items that are allocated to the "services" component are added together, to determine the business indicator. This covers, among other things, other operating income and expenses. As the income and expenses from leasing business are allocated to other operating income and expenses, the leasing income and leasing expenses from financial and operating leasing are also to be added. However, this completely fails to do justice to the specificities of leasing business, since when it comes to the financing function for the lessee, leasing is highly similar to lending. Leasing business is thus included in the standardised and IRB approaches to credit risk. Adding leasing income and leasing expenses within the framework of the business indicator leads to a drastic increase in the capital requirements for leasing business compared with the current rules. Leasing business is thus subjected to much heavier capital charges for operational risk than lending business, since income and expenses are to continue to be netted for the interest component. Such discriminatory treatment is not justified by the risk profile. The operational risk profiles in lending business and leasing business do not differ to any significant extent. Both the lessor and the lender finance an object (financing function) so that the lessee or borrower can use it (utilisation function). Because of the lessor's undisputed legal ownership position, the legal risks are actually much lower compared with a collateralised loan transaction.

Moreover, for leasing transactions, the same argument as that put forward for the netting of interest income and interest expenses in the case of interest-bearing loans applies: leasing income and, correspondingly, interest expenses from refinancing may differ in amount depending on the respective currency and business cycle, but different operational risks cannot be inferred from the general interest rate level incorporated in these. Assuming that margins remain constant, the proposed methodology would lead in periods of high interest rates to increased capital requirements for operational risk, although no expansion of operational risk would be involved due to the lack of correlation.

In addition, leasing business, like lending business, displays a close economic connection. Like in interest-earning business, leasing income is not economically conceivable without leasing expenses. With leasing, the economic connection is in fact even closer than with lending, where refinancing funds may be used also for services that have nothing to do with the provision of the services. In leasing business, this is, by definition, ruled out as leasing expenses are then no longer involved. Adding leasing income and leasing expenses cannot be justified as a leasing transaction can create only a single operational risk exposure, yet this exposure would have to be covered twice – once through income and once through expenses. Leasing business thus differs from transactions for which there is an income item but no corresponding expense item or an expense item but no corresponding income item.

The argument put forward in the consultative document that netting of income and expenses within the services component leads to an underestimation of the operational risk exposure from business activities does not apply to leasing either. The net leasing profit or loss is therefore the only appropriate indicator for the operational risk exposure from leasing transactions. That goes for both financial leasing and operating leasing.

Unless a net approach is adopted in leasing business, similar operational risk will additionally lead to widely different capital requirements for operating leasing and financial leasing. This is because in operating leasing, unlike in lending business, the special accounting rules mean that the repayment portion comprised in the lease rental to amortise the difference between the cost price and the calculated residual value of the leased object has to be reported as income. The repayment portion included in the lease rental does not, however, constitute an income component in economic terms. Reporting leasing income on a gross basis would consequently distort the business indicator. Unless the repayment portion comprised in the lease rental was adjusted, the result would therefore be a drastic increase in the business indicator that would not be justified by the operational risk.

Because economic ownership is assigned to the lessor, not the leasing receivables but the leased objects have to be reported in operating leasing. This means that the value of the asset has to be reduced not by repayments but by depreciations. As depreciations are unlikely to differ significantly from repayments over the leasing period, we suggest for simplicity's sake that, in line with the treatment in the income statement, leasing income should be reduced by depreciations.

In financial leasing, on the other hand, the interest income included in the leasing income should, like in lending business, be reduced by the interest expenses included in the leasing expenses. As a result, where operational risks are similar, the similar exposure, i.e. the amount to be financed by the lessor for the object, means that the business indicator can be determined similarly.

Unless an appropriate net approach is adopted in leasing business, the problems would be aggravated by the fact that the criteria for assigning economic ownership of the leased object have not been harmonised globally. Assignment of economic ownership of the leased object and thus the answer to the question of whether the lessor is required to report a leasing exposure (financial leasing) or the leased object (operating leasing) thus differ from country to country and from accounting regime to accounting regime. Where similar transactions are involved, nationally differing accounting regimes may lead under a gross approach to structurally widely divergent capital requirements, as operating leasing agreements would face a much higher capital charge compared with financial leasing where similar risks are involved. Depending on where and according to which accounting standards a leasing transaction had to be reported, the capital charge for this transaction would vary significantly because of the different size of the business indicator. A net approach solves this problem, since where similar transactions are involved, the leasing profit or loss does not differ to any significant extent.

Another argument in favour of a net approach is that the proceeds from the sale of leased objects also have to be reported after the leasing period as leasing income and their derecognition has to be reported as leasing expenses. Only a net approach will result in an appropriate consideration of the lease agreement in the business indicator.

To ensure a level playing field, leasing business should therefore be treated in the same way as lending business. As outlined in the main document, we suggest expanding the interest component to include

“similar economic income and expenses”. This would make clear that the issue is allocation of leasing business based on economic considerations and not on the accounting concept.

<u>Example 2 – Institutions with a special distribution channel</u>

An institution has structured its business model in a manner such that its own financial products are distributed through a network of third-party distribution partners. This structure is reported on the income statement as follows: whilst fees paid by investors are initially recognised as commission income in full, the share of commission due to distribution partners is recognised as commission expenses. The notion that commission expenses are also exposed to operational risk (both income-generating and cost-causing processes may give rise to operational risk) is generally permissible, provided that actual services were rendered to the institution in conjunction with such commission expenses. However, in the context of devising an indicator for operational risks, incorporating commissions recognised – but subsequently passed on to distribution partners – is not an appropriate approach. On the one hand, this 'gross' inclusion of income and expenses will increase commission income but also commission expenses – which would lead to a duplicate cover of commissions paid to external third parties. In fact, however, commission paid to distribution partners constitute a 'pass-through' item, compared to a syndicated loan, for example. Interest income and expenses may be set off against each other when determining the interest component, due to the fact that interest-related flows are "closely tied to each other". The same argument must be applicable to calculations in the context of the service component. Given that any commissions passed on are directly dependant upon commission income realised, we believe the systematic addition of commission income and expenses to be an unjustified duplication of one and the same transaction that would lead to a multiplication of current capital requirements. We therefore propose to flesh out the requirements concerning inclusion of commission income and expenses to the extent that items not related to any separate service should not be included in the relevant indicator. In this scenario, exempting certain parts of commissions – instead of incorporating commission income and expenses on a gross basis – would be more appropriate.

We have compared the new standardized approach to the current simple approaches in a significant part of the German banking industry. The results for universal banks and specialized institutions which are well characterized by this example, are as follows. Both groups of financial institutions are comparable in their business focus on retail business, governance, structure of ownership, regional focus and management culture. When operational risk profiles are made comparable, under the BIA and TSA currently in use, the specialized institutions have a capital charge slightly above that of the universal institutions. Under the new SA, the universal institutions benefit from a slight reduction of their capital requirements for operational risk while the specialized institutions suffer an additional increase of their capital charges by approx. 30%.

<u>Example 3 – Institutions offering a single customer product</u>

A subsidiary of a financial conglomerate primarily distributes one product only, generating income from interest margin and a portfolio-based commission paid on a regular basis. That institution's capital requirements are already, at present, exaggerating existing operational risk exposure. In fact, the proposed revision of the Standard Approach would triple capital requirements – even though the operational risk exposure of a single customer product continues to be very manageable indeed. The proposed calculation of the service component would not appropriately reflect the business model in this example as well, and would grossly exaggerate operational risk exposure.

What needs to be taken into account in this context is the fact that consolidation includes commission expenses paid by companies that are not subject to capital backing (due to banking regulations) and which cover risks through fund assets, for example (as is the case for fund management companies or leasing companies).