



Institute
and Faculty
of Actuaries

Operational risk – Revisions to the simpler approaches

Consultation response to the Bank for International
Settlements

6 January 2014

About the Institute and Faculty of Actuaries

The Institute and Faculty of Actuaries is the chartered professional body for actuaries in the United Kingdom. A rigorous examination system is supported by a programme of continuous professional development and a professional code of conduct supports high standards, reflecting the significant role of the Profession in society.

Actuaries' training is founded on mathematical and statistical techniques used in insurance, pension fund management and investment and then builds the management skills associated with the application of these techniques. The training includes the derivation and application of 'mortality tables' used to assess probabilities of death or survival. It also includes the financial mathematics of interest and risk associated with different investment vehicles – from simple deposits through to complex stock market derivatives.

Actuaries provide commercial, financial and prudential advice on the management of a business' assets and liabilities, especially where long term management and planning are critical to the success of any business venture. A majority of actuaries work for insurance companies or pension funds – either as their direct employees or in firms which undertake work on a consultancy basis – but they also advise individuals and offer comment on social and public interest issues. Members of the profession have a statutory role in the supervision of pension funds and life insurance companies as well as a statutory role to provide actuarial opinions for managing agents at Lloyd's.



Name
Bank for International Settlements
Centralbahnplatz 2
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Switzerland
CH-4002 Basel

6 January 2015

Dear Sirs

IFoA response to Operational risk- Revisions to the simpler approaches

1. The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to respond to the Basel Committee on Banking Supervision's consultative document 'Operational risk – revisions to the simpler approaches'. The IFoA's Risk Management Board has led the drafting of this response. The group includes members with operational risk experience in the banking sector.

General comments

2. The consultative document notes (paragraph 47) that operational risk capital is no substitute for effective controls and operational risk management. However the IFoA is concerned that low standardised capital requirements may inhibit efforts to better understand operational risk exposures. A low Standardised Approach (Alternative Standardised Approach) figure discourages firms from pursuing Advanced Measurement Approaches which involve a properly detailed analysis of operational risk exposures, but this is unlikely to be pursued if it results in significantly higher capital requirements. In addition, there is a risk that scenario analysis may be compromised if low regulatory capital requirements "anchor" the loss estimates of those carrying out the analysis.
3. We believe the data used for the initial calibration may have been immature and did not capture sufficiently many catastrophic events. This appears to have resulted, not just in operational risk requirements being lower than they should have been, but also in a lower take-up of Advanced Measurement Approaches than would be ideal, and may have skewed scenario analysis. Given that loss experience may still be immature, and the distortions that low standardised requirements may introduce, we believe that operational risk capital requirements should err on the cautious (high) side.
4. A greater focus on scenario analysis should give a prospective picture of operational risks emerging against exposures and controls, rather than the backward looking perspective of historic loss data.
5. It is our view that the nature of operational risk is more akin to general insurance than banking. It is a diverse category, covering everything from cyber attacks to mis-selling, processing errors and floods. Furthermore, there is often a lag between losses being incurred and when they crystallise. Whilst there is evidence that Standardised Approach /Alternative

Standardised Approach capital has fallen with income while losses are rising, many of these losses were incurred pre-crisis (e.g. PPI mis-selling in the UK), although they are only emerging now. Under these circumstances, we believe there may be a case for a standardised measure to consider the maximum of indicator values over a period (for example 5-10 years) to pick up where fee and other income may be buoyant, but where latent operational losses may be incurred.

6. We would also emphasise that operational risk tends to be idiosyncratic, i.e. very specific to individual firms, with different banks having different exposures and levels of control. We believe this is likely to lead to some degree of diversification with credit risk - which the regulatory capital framework should recognise.
7. The idiosyncratic nature of the risk makes the implementation of an effective standardised approach challenging since often too much, or too little, capital will be held at a desired confidence level for a specific bank's risks.

Question 1. Are there any other weaknesses in the existing set of simple approaches that should be addressed by the Committee?

8. The IFoA believes that the Committee should consider the negative implications of low standardised requirements on wider operational risk management practices and disincentives to pursue Advanced Measurement Approaches.
9. It should also consider the timing effect and that operational losses arising in a given year may relate to income from previous years.

Question 2. Does a single standardised approach strike an appropriate balance across the Committee's objectives of simplicity, comparability and risk sensitivity?

10. The IFoA believes that a standardised approach will rarely match the capital required for a given bank, given the idiosyncratic nature of exposures. We would suggest that the aim should be for those that can pursue Advanced Measurement Approaches to be encouraged to do so. For other banks, even sophisticated standard methods may still prove inadequate in some cases.
11. We welcome the amalgamation of the different lines of business, particularly given there is limited statistical evidence to support this as a differentiator of risk. We would note the comment in paragraph 32 (on the decreasing suitability of the definition of some lines of business in light of changing models) and highlight that some supposedly lower risk activities, like retail banking, have given rise to sub-prime lending in the US and PPI mis-selling in the UK.
12. We would question the tiering of the Business Indicator by size – the lower requirements for smaller banks may be due to a lack of data. In our view, if loss distributions calibrated to more extensive data for larger banks can fit smaller banks' loss experience, then there would be value in adopting these distributions for all.
13. We note that the Pareto heavy distribution was rejected, when validating the operational risk capital-at-risk calculator (Annex 2, paragraph 16), and would urge the Bank for International Settlements to re-examine this result. Recent large losses (such as PPI mis-selling, settlements in relation to sub-prime securitisation, and fines for LIBOR fixing) suggest that operational risks may follow heavy tailed distributions; and this seems in contradiction to the

proposals. We would suggest that the data may be limited in terms of the number of catastrophic events it captures.

14. There may be a case for adjusting the Interest component of the Business Indicator to address issues for banks with high net interest margins, and we comment on this in more detail below.

Question 3. Are there any further improvements to the Business Indicator that should be considered by the Committee?

15. We would question why the absolute value of changes in the value of available for sale assets - and other items that may not flow through P&L - are being excluded from the Business Indicator measure. Considerable balance sheet volatility can arise from these assets, as well as operational risk, such as valuation errors.
16. We would also question the exclusion of staff expenses; as an example of the changing nature of operational risk, many UK banks could face significant employee relations liabilities in relation to recent legal judgements on overtime, bonus and holiday pay. This example highlights the fact that operational risk is not an isolated issue that only impacts the provision of banking services to customers.
17. There will also be operational risks attaching to provisioning - including systematic under-reserving or errors in the application of provisioning standards.
18. The banking book P&L component of the Financial element could introduce double counting, since it includes elements of the Interest and Services components. Excluding the absolute value of banking book P&L, and just focusing on the trading book P&L, could improve the fit of the calibration of the Financial element.
19. There may be benefit to placing a relatively low weighting (for example 50%) on the Interest component. Aside from addressing issues with banks with high net interest margins, we would note that many operational losses have been incurred when banks moved away from a model of generating net interest income to generating fees and other income. Presumably applying a lower weighting to this component would necessitate a greater weighting towards other components, but it may be that fee related business and trading could generate higher operational risks.
20. There may be a case for allowing a diversification benefit with credit risk that may offset some of the increase in operational risk requirements. The advantage of a high standard figure, with a reduction for diversification, over a lower figure, without diversification, is that the latter may act as a disincentive to pursue Advanced Measurement Approaches and could introduce bias into operational risk analysis.
21. In terms of balance sheet alternatives (as well as off-balance sheet activities and the volatility of values) we would note that further distortions could be introduced by asset sales. There is a risk that asset sales could reduce capital requirements but that operational risk is not transferred under the terms of warranties granted as part of the sale.
22. We would suggest basing the Business Indicator figure on the highest value in the past 5-10 years in order to address (a) the issue with falling indicator values in depressed conditions and also (b) the lag effect, in which latent exposure arises during "boom" conditions, but only

emerges some years after. This would also address the situation where a bank has downsized its operation but still retains considerable legacy exposure.

Question 4. What additional work should the Committee perform to assess the appropriateness of operational risk capital levels?

23. We are not convinced about the non-linearity of requirements by size, given the more limited data availability for the lower buckets. The IFoA would welcome a simulation study to examine whether the loss distributions fitted to the higher buckets could generate similar levels of loss to that observed in the lower buckets. This would enable an analysis of the distributions to determine if they are plausible for modelling the losses of smaller banks.
24. There should also be some consideration of whether there may be 'survivorship bias' in the sample of smaller banks (i.e. overlooking in the analysis those institutions that failed).
25. As stated in response to question 3 above, consideration should also be given to the degree of diversification with credit risk and whether a diversification benefit between the two risk types should be allowed.

Question 5. Are there any other considerations that should be taken into account when establishing the size-based buckets and coefficients? How many Business Indicator buckets would be practical for implementation while adequately capturing differences in operational risk profiles?

26. We would welcome clarification on whether the number of banks in each bucket will be approximately equal and/or whether there will be a minimum number of banks in each bucket.
27. We note that the consultation document highlights the issue of limited available data for the lower buckets (paragraph 34). We would urge the Committee to address this in the new Quantitative Impact Study exercise and would welcome confirmation as to whether this is likely to be the case.

Question 6. Are there any other considerations that should be taken into account when replacing business lines with size-based buckets?

28. The change from business lines to size based buckets could lead to significant changes in operational risk capital for some banks. Whilst we do not have specific considerations to highlight, we would welcome a commitment from the Committee to undertake and publish an impact assessment and to consider whether transitional arrangements to minimise the short-term impact on individual banks would be appropriate.

Question 7. Could there be any implementation challenges in the proposed layered approach?

29. We support the layering approach as an appropriate way to ensure that there is a smooth increase in capital charges, as the Business Indicator increases. We note that, for banks near or at the top of a bucket range, the effective coefficient can be significantly less than the coefficient that applies to most of the components of the Business Indicator for that bank. For example, if the Business Indicator is E3,000m, the coefficient is 17% - but the effective coefficient is only 15.7%. We would suggest that the Committee explores whether it would be appropriate to introduce a mechanism that aligns the effective coefficients with the theoretical operational capital requirements.

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?

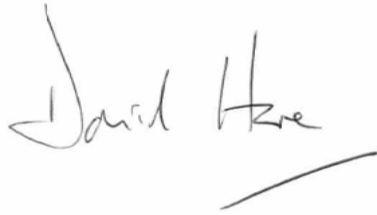
30. We note that banks do have the option to pursue Advanced Measurement Approaches if they feel the standard formula is not appropriate to their risks; ideally, those large internationally active banks that can go down the Advanced Measurement Approaches route will do so.
31. Nonetheless, as stated above, we believe there may be a case for applying a weighting of considerably less than 100% to the Interest component in the Business Indicator calculation. Aside from helping to address the issue of banks with high net interest margins, this may be appropriate - given the risk profile of fee business and trading books which go to make up the other components.
32. We do not believe it is appropriate to adjust the standard formula for highly specialised fee businesses. Often, operational risk is the key risk for such businesses and there is little diversification with other risks. The consequences of low regulatory capital requirements for operational risks are greater for highly specialised fee businesses and it is appropriate to increase the capital to reflect more closely the true underlying exposures. To the extent that the increase may be excessive, such firms have the option to pursue Advanced Measurement Approaches - which should be encouraged if operational risk is their key risk.

Question 9. What would be the most effective approach to promoting rigorous operational risk management at banks, particularly large banks?

33. The IFoA believes that the qualifying criteria for the Standardised Approach /Alternative Standardised Approach should be extended to all banks if the revised standardised approach is to become the "entry level" capital methodology.
34. The requirements for large international banks listed in Annex 4 do not seem particularly onerous: operational loss data collection should be collected as part of "business as usual" management of costs, while the operational risk management outlined in part B should be in place in most banks.
35. We do believe historic loss data is insufficient to gauge a comprehensive operational risk profile and would support a forward looking scenario analysis. We believe this approach, which would seek to identify low frequency, high impact losses that may not be in data, is essential to properly understand and manage operational risks. We would urge the Committee to include more detail on the need to perform scenario analysis, at a suitably granular level; to get the input of experts across the business; to have independent review and challenge of scenarios and impacts; and to engage senior management on results, including signing them off to the Boards of their firms.
36. Furthermore, we would suggest that regulators consider scenario analysis results and Pillar II capital against major loss events arising. This would illustrate the extent to which a loss was anticipated and, if it was not, whether it should have been. To the extent that a bank is found wanting in its scenario analysis and how risks have been incorporated into its ICAAP, there may be a case for a regulatory capital add-on to address poor risk management practice.

Should you wish to discuss any of the points raised in further detail please contact Matthew Levine, Policy Manager in the first instance (matthew.levine@actuaries.org.uk / 02076322125).

Yours faithfully

A handwritten signature in dark ink, appearing to read 'David Hare', with a long horizontal flourish extending from the end of the name.

David Hare
Immediate Past-President, Institute and Faculty of Actuaries