International Banking Federation

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Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
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Email: baselcommittee@bis.org

5th January 2015

Dear Sir/Madam:

Re: ***Response to the consultation on operational risk - revisions to the simpler approaches***

We appreciate the opportunity to review the Basel Committee's consultative document, "*Operational risk - Revisions to the simpler approaches*". We recognize the work of the Basel Committee to develop a new approach in order to streamline the framework and address weaknesses identified in the existing approaches.

We understand that the Basel Committee is considering whether or not to replace the current non-model-based approaches with the proposed Business Indicator (BI) approach. However, we are concerned that the proposed approach is much more complex than it might at first appear, and despite this complexity is not sophisticated enough to incorporate known risk drivers. We believe that implementing the proposed approach will burden banks' existing resources with little benefit in terms of improvement in risk measurement or risk management capabilities or practices. We recommend that the Basel Committee reconsider the proposed approach.

For your consideration, we have provided our comments on some key issues below.

Design concerns

Although the Operational Risk Capital-at-Risk (OpCaR) model is a quantitative model based on banks' internal loss data, it is overly simplistic and not risk sensitive. This is true of the Revised Standardized Approach (RSA) as well. These fundamental characteristics mean that their results are not comparable across banks. As such, we believe that they are not aligned with the Basel Committee's desire to appropriately balance simplicity, comparability and risk sensitivity. We are concerned that the outcomes of the RSA model may not serve as an indicator of forward-looking unexpected operational losses, and are merely a new single, non-linear ratio of the relative quantum of modified gross income.

We find that the models do not adhere to generally accepted principles of the alignment of risk management and risk measurement. The elimination of differentiation of risk by the mandatory modelling of all risk within one operational risk category (ORC) is counter-intuitive. The approaches are not monotonic; on the contrary, they introduce the concept that diversification results in higher losses, which is conceptually unsound.

We are concerned that the only solution to reducing the operational risk capital charges will be for an institution to shrink in size or become more concentrated by focusing on products and services that earn lower levels of modified gross income on lower levels of unexpected credit and market risk in order to improve returns on assets and equity.

We consider that the proposed models (OpCaR and RSA) pose unquantifiable and unacceptable levels of model risk, and also represent models that are disengaged from banks' risk management practices. As a consequence, boards and management are likely to view the outcomes as having no relationship with operational risks in their business, and thus unfit for the purpose for which they appear to have been designed.

In addition, we believe that the Basel Committee's Quantitative Impact Study (QIS) should carefully review the interaction of the new proposal with the implementation of the combined buffer requirements.

Incentives to improve operational risk management practices

Strengthening the link between risk measurement and risk management is an imperative for both the industry and its effective regulation. In the current simpler approaches, there are minimum standards for risk management practices that an institution is required to meet as part of accreditation requirements. With increasing levels of complexity, the banks need to more carefully evaluate their capital requirements and are expected to have sophisticated and robust risk management practices. The Advanced Measurement Approach (AMA) further incorporates the loss experience of the institution in determining the level of capital requirement, which provides a strong level of incentive for financial institutions to improve risk management practices. While capital requirements are a means to protect against exposure, sound risk management practices are fundamentally the key to ensuring continued safety and soundness of financial institutions. As such, it is recommended that the linkage to incentives for sound risk management practices be incorporated in any proposed approaches.[1]

More importantly, since the AMA provides the best incentives for improvement of sound operational risk practices, in our view this approach should be preserved, and its ability to incent good risk management practices should not be impeded by a restrictive capital floor based on simpler approaches.

Many global and domestic systemically important banks (G-SIBs and D-SIBs) around the world have spent over 10 years developing their AMA models. There has been considerable knowledge accumulated through the use of such methodologies, and the AMA is becoming a

[1] For reasons noted below, it may be desirable, in terms of both transparency and ease of implementation, to develop an approach that accounts for the benefits of risk mitigation actions after operational risk has been quantified.

more refined predictor of operational risk (e.g. scenarios provide more of a leading indicator around risk levels). As the AMA tools (both quantitative and qualitative) are refined and with increased disclosure of approved model results, we expect that there will be a narrowing of best practices and increased consistency and comparability between the AMA results from complex institutions. As such, we do not believe that standardized approaches are the only way to achieve comparability.

We also believe it would be a significant loss to the risk management discipline if international incentives were not maintained for these useful and informative AMA tools. Complex institutions require more than "one-size-fits-all" simplified models, which do not effectively capture the full spectrum of risks to the organization and the financial system.

Level of operational risk exposure

One important goal for a capital regime is ensuring comparability of capital for institutions with similar risk exposure or profile. The proposed approach does not appear to meet this principle on two levels: (a) inadequate representation of risk drivers, and (b) issues with calibration.

a. Risk drivers

The industry collectively has made considerable progress in reviewing risk drivers as part of the work effort to implement the AMA. General observations from that work suggest the size of an institution is not a reliable predictor of exposure.

In particular, it is observed that different business lines and different jurisdictions are significant risk drivers. Relying on size of operations as the sole determinant of operational risk does not meet the stated principle of "enhanced risk sensitivity", nor does it calibrate according to the operational risk profile for different business models. As an example, take two banks with different business models, one a chiefly retail lending bank (with stable earnings mainly from the interest components) and compare it to a bank that predominantly does trading activities (earnings derived mainly from volatile financial components). These two banks can have the same level of capital if the total earnings are the same, whereas the sources of risk for the two vary significantly.

The proposed approach is regressive compared to the current Standardized Approach (TSA), where both size and business lines are considered in determining capital. We believe that the proposal should address the impact of income volatility from higher risk businesses and, at a minimum, should continue to use business lines to differentiate the inherent operational risk profiles of the underlying business activities.

b. Calibration

One of the weaknesses of the current simpler approaches is that they have been calibrated based on poor quality data (i.e. without extensive loss databases and with only the model experience in existence in the early 2000's). Rather than spending resources to develop another proxy (i.e. BI), we think that there is merit in exploring ways to improve the existing TSA and current historical data. We believe that a revised TSA should be factored into the next iteration of a simpler approach.

Indeed, we consider data inadequacy to be one of the key flaws of the existing TSA and Basic Indicator Approach (BIA) since they were calibrated using incomplete loss data predating 2006. As such, we believe the current TSA could easily be improved by calibrating the betas based on the most complete and recent loss data. Furthermore, the TSA methodology would need to be enhanced to take into account higher risk businesses that experience greater levels of volatility in gross income, particularly decreases in gross income. To ensure ongoing relevancy, we would also recommend that periodic review and calibration be scheduled for the simpler approaches. Ongoing back-testing could refine the operational risk measurement. These remedies are much less resource intensive than the development of a brand new and untested standardized approach. Enhancements to the TSA can result in a methodology that is more responsive to differing business models and the complexity of a financial institution rather than the proposed approach, which is based solely on size.

High Interest Margin Business Lines

The RSA's inclusion of a proposed interest component would introduce the likelihood of double-counting of required capital for banks having certain business models. For example, in certain markets, credit cards and other unsecured consumer credit products carry a relatively high interest rate, which is intended to compensate the lending bank for the credit risk presented by those products. The components of regulatory capital intended to protect against credit risk already take into account the credit risk of these products. Requiring additional capital under OpCaR and the RSA based simply on the resulting net interest margin, which probably has no relationship to the business line's operational risk, imposes an excessive capital requirement for risks that are already adequately addressed.

Business Indicator for leasing business and fee business

The RSA penalizes the leasing business and fee business in comparison to the credit business, which we believe is unfounded. In our view, operational risk for the leasing business is equivalent to the risk for the credit business since the leasing business is typically secured in a manner that decreases operational risk. We also note that accounting standards treat income and expenses from leasing in separate income statement lines. We question why the leasing business should be treated as other operating income or other operating expenses for calculating capital requirements. Since the leasing business is economically similar to the credit business, we propose that income and expenses from leasing should be treated similarly to income and expenses from the credit business. We propose that the interest component should be extended to "economically similar income"; specifically, if interest income is scored net of interest expense, then functionally equivalent leasing income should likewise be scored net of related business expense. If a bank has its main focus on fee business or leasing business, it should be allowed to recognize the income and expenses as a net position.

Referring to the service component, we propose a maximum approach, which means the service component considers the fee income or the fee expenses, whichever is higher, plus other operating income or other operating expenses, whichever is higher. The formula would be:

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

The advantage would be that a business transaction would not be taken into account twice if the transaction produced income and expenses. Also, a business transaction (income) where the bank has taken risk mitigation measures (expenses) would not be penalized for these measures.

Treatment of partial usage

It is unclear what coefficient to apply in cases where an AMA banking group is partially using the standardized approach. We believe it is more appropriate to use the coefficient applicable to each individual legal entity (i.e. not the group coefficient) under the standardized approach. In addition, intragroup transactions should be excluded from the BI calculation for each individual legal entity. Nevertheless, as noted above, it is critical to incent banks' operational risk mitigation activities and to account for their benefits in determining required capital. Accordingly, if operational risk mitigants are implemented on a group-wide basis, or otherwise are not accounted for at the subsidiary level, we believe that the framework must be sophisticated enough to take them into account.

Complexity of implementation

We are not convinced that implementing the proposed simpler approach is indeed "simple". It would require considerable work effort to retrofit existing operational risk data sources into a new methodology. Furthermore, the complexity of the BI will create challenges in the ability to verify the completeness and accuracy of its calculation.

We note the following complexity in the implementation of the proposed approach:

- The proposed components of the BI do not align with financial accounting practices. As such, significant work will be required to:
  - ensure consistent interpretation between jurisdictions and financial institutions;
  - implement the changes; and
  - provide ongoing supervisory monitoring for compliance.
- The proposed BI buckets are based on Euros, and they would need to be continually adjusted to ensure a level playing field across different currencies as exchange rates change.

Given our past experience in mapping gross income for the TSA, which was a significant work project, this will serve to divert scarce resources from efforts to enhance the measurement and management of operational risk through ongoing AMA development and maturation of the sound principles for the management of operational risk.

Timing

We would appreciate clarification on the expected timeframe for implementing this approach. This is particularly relevant due to the expected material increase in capital required under the proposed approach.

Conclusion

Overall, we believe the proposed changes do not improve risk sensitivity or enhance the link between risk measurement and risk management, and they divert resources from current efforts in these areas. Furthermore, given the inherent flaws of the proposed approach, we are concerned with the intent to use it as a floor or to benchmark the AMA. As such, we would prefer to enhance the existing TSA since it better recognizes the underlying risks in the various business lines rather than emphasize only the size of a financial institution. Not only is this approach more closely aligned with the way banks manage risk, but after simple improvements as mentioned above, we believe it would be more effective in preserving the incentives and resources to enhance more sophisticated risk management capabilities, and promote the corresponding evolution to the AMA approach for complex institutions.

We thank you for taking our comments into consideration, and we look forward to future discussions on these issues.

Yours sincerely

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