

To: Basel Committee Workgroup Operational Risk (WGOR)
(internet consultation)

Date 23 December 2014

Reference BR2288

Subject: NVB reaction to BCBS291 Consultation: operational risk
revisions simpler approaches

Dear Sir, Madam,

On behalf of the Dutch Banking Association (NVB) I would like to thank you for giving us the opportunity to react on Consultation Paper BCBS291 – Operational risk – Revisions to the simpler approaches. As the original Standard Operational Risk framework was designed some years ago now we welcome such a review, however we have concerns regarding the currently proposed implementation.

Next to the answers to the specific questions (see Appendix), we would like to share a number of general remarks and concerns. These pertain to:

1. Concerns around Advanced Measurement Approach (AMA) framework
2. Risk sensitivity, interaction with Principles
3. Business Lines differentiation
4. Consolidation and accounting definitions
5. Timing and impact
6. Transparency of the OpCar model

Ad 1 – Concerns around Advanced Measurement Approach (AMA) framework

The revised Standardised approach is suggested to become a floor for AMA. Over the years highly valuable AMA framework best practice knowledge and risk culture has been built up, in particular the processes around the Use Test: risk identification, risk measurement, risk tolerance and risk mitigation. Results of AMA are integrated in everyday future-oriented operational risk management processes now.

Unless the floor is set at a reasonable percentage of AMA capital levels, an increased level of Standardised operational risk capital above current AMA levels would act as a lever for banks to unwind this valuable AMA framework. As a result the Use Test being the cornerstone of AMA would be at stake.

We suggest a phased approach: implement a revised Standardised approach and calibrate the new method over a number of years before considering it as a suitable floor for AMA.

Ad 2 – Risk sensitivity, interaction with Principles

We note that in October a number of Principles were released in regards to operational risk. The newly proposed standardised framework does not have any link with these Principles. Furthermore, we do not believe the proposal to enhance risk sensitivity. Capital charge does not change with evidence of prudent risk management, only with changes in size resulting in potential cyclical effects. Finally there is no established framework to review calibration of the Standardised framework.

We suggest a new Standardised approach should be calibrated yearly.

Ad 3 – Business Lines differentiation

Industry studies (ORX - Operational Riskdata eXchange Association) have found evidence of differences in operational risk profiles between business lines. We cannot reconcile the proposal's data findings with these studies. We therefore cannot verify the data quality and soundness of the proposal's modelling.

We recommend the committee adopt the table of business lines as proposed by the industry via ORX.

Ad 4 – Consolidation and accounting definitions

We strongly recommend one consolidated calculation per bank, on a group wide basis and based on clear existing accounting definitions. For example, Banking and Trading book are mentioned both of which are undergoing major regulatory reviews. A large number of parallel regulatory reforms and information requests from various regulatory bodies in particular in Europe are increasingly putting undue pressure on reporting functions.

We request that data definitions are fully aligned with current international financial and regulatory reporting standards, not requiring a new or different set of financial statements for operational risk capital calculations.

Ad 5 – Timing and impact

We note the deep impacts of the current proposal and recommend that a diligent Quantitative Impact Study (QIS) process will be deployed in 2015 based on the 2014 figures. A number of large regulatory change programs are being completed by our members which will change financial statements throughout the industry in the next years.

We ask for the new Standardised model to be calibrated over a three year period.

Ad 6 – Model Transparency

The OpCar model and its application to the dataset is only described in terms of formulas without any information on the calibration. However, it is only possible to assess the quality of the OpCar model and the resulting The Standardised Approach (TSA) if the underlying dataset, estimated parameters and calibrated distributions are disclosed fully. In this regard, currently only (educated) guesses can be made what part of the OpCar model causes the increase in standardized capital.

We ask to disclose all information on the model and its calibration such that banks can assess the resulting TSA and compare it with their own (AMA) model.

In summary, we would like the committee to consider the following:

- Develop a new Standardised approach based on TSA with the business line sensitivity built in following the 2014 figures QIS exercise during 2015. Ensure due process is followed in reviewing the results.
- Implement this new Standardised approach with yearly calibration and then consider after a 3 years of stability in the new Standardised approach how it could eventually function as a floor for AMA.

We thank the Committee for this consultation and refer to the appendix for further specific answers per question.

Kind regards,

Arnold Veldhoen
Advisor Prudential Regulation

Appendix: answers to each of the BCBS291 questions.

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

The current simple approaches (and proposed new one) do not make use of operational risk loss data or any non-financial risk indicators commonplace in best practice operational risk management. The framework therefore does not link capital requirements to risk prevention and mitigation behaviour. Furthermore if the basis for the risk indicator is only to become historical loss experience then a regular review of the standardised approach's calibration is required.

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

We agree that one standardised approach for operational risk replacing BIA, TSA and ASA will suffice for the industry. However it requires risk sensitivity to be incorporated in the design. Within the standardised approach the heterogeneous nature of supervised institutions needs to be acknowledged and appropriate incentives need to be inherent in the supervisory framework.

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

In its current design the BI may work pro-cyclical. When an institution reduces in size involuntarily (loss of market share) this may be a sign of inadequate design and operation of products and services which would warrant the need for more operational risk capital – not less.

Although we can understand that netting fees or other BI's does not lead to the correct volume as risk indicator we find that summing absolute values introduces over-calculation. We would suggest the highest of either fees received and fees paid without netting. The simple thought behind this is that the risk is included in the service. With the proposed summation a company outsourcing practically everything would almost double its fees for ultimately the same services delivered. We are of the opinion this is a flawed concept. The suggestion might also reduce the effect on high fee business.

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

Financial statement information alone does not give a full insight into operational risk. The business environment and risk management practices need to be taken into consideration to some degree as is the case in AMA. At the moment the earlier designed Principles are not incorporated in this operational risk capital consultation.

Q5. Are there any other considerations that should be taken into account when establishing the size-based buckets and coefficients? How many BI buckets would be practical for implementation while adequately capturing differences in operational risk profiles?

We recommend against the use of buckets. A continuous function (exponential or log) is superior to a bucket/table calculation in day to day implementation. We also strongly recommend to avoid building in sensitivity to exchange rate volatility.

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

We recommend to not lose the business lines differentiation in the new standardised approach. Intuitively and empirically (refer to ORX studies) the operational risk profiles of retail savings banks, investment bank trading desks or clearing/custody business lines are too distinct to fit into one model. The 2015 QIS study will highlight these issues, for example the impact on leasing business lines versus lending or trading. We recommend the committee adopt the table of business lines as proposed by the industry via ORX.

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

The implementation as such does not appear to be wrought with complexities. It is however of the utmost importance that data definitions are fully aligned with current international financial and regulatory reporting standards (for example established IFRS, Corep, Finrep), not requiring a new or different set of financial statements for operational risk capital calculations.

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

We would feel that business model heterogeneity needs to remain in the new standardised approach by the use of business lines.

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

Best practice operational risk management is displayed by banks that typically have deployed the full AMA framework including future-oriented risk and control management practices, aligned with the principles for sound operational risk management. A revision and standardisation of AMA confidence levels is likely to bring about more standardisation of operational risk capital in the industry.

The following comments can be made with respect to the OpCaR methodology

- There is independence assumed between frequencies and severities. It seems counterintuitive that such a model would yield higher capital than under the AMA model. Also the level that this OpCaR model supersedes the AMA model capital is surprising.
- There is a small number of AMA banks in the initial set. Later on some AMA banks are also classified as an outlier and removed from the dataset on which the OpCaR model is estimated. See page 31 under section 15.
- The average frequency λ is estimated using the sample analogues of λ_u and $F_X(u)$, see formula 4 on p 25. How sensitive is the estimate of λ on these estimates and how sensitive is the OpCaR level with respect to λ .
- Why are different conditions used for each of the severity distributions in table A.7? Some use the percentile while others use the maximum conditions.
- How sensitive are the estimates of the severity distribution with respect to the conditions used?
- What happens to a model if the AIC cannot be computed?
- We would like to know the final estimates of θ, A, α from formula 9 that were used to derive table 2.

- In case a bank was in the initial dataset we would like to know the relevant parameters estimated for that bank such as
 - o n_i, n_i^* , $i=1,2,\dots,5$,
 - o λ_u for $u=10,000$ and $u=20,000$
 - o The values of the quantities on the right hand side in formulas (6), (7) and the left hand side of both items in (10).
 - o Estimates of all the parameters of the severity distributions as those in table A.8

We thank the Committee for this consultation.

Kind regards,

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