



POLISH BANK ASSOCIATION

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Ref. Polish Bank Association response on the BCBS second consultative document "on the Standardised Measurement Approach for operational risk "

Dear Sirs,

The PBA welcomes the opportunity to express the view of the Polish banking industry on the second consultative document on the Standardised Measurement Approach for operational risk which replace current approaches for operational risk by a single non-model-based method.

General remarks:

Having in mind the justification by the Committee, why AMA methodology is planned to be replaced by the SMA model, we agree that lack of comparability is a problem. But we are of the opinion that the stakeholders should focus on developing and promoting common standards for AMA, instead of simple replacing it by much more simplified and less risk-sensitive SMA model. Moreover – withdrawing AMA model reduces incentives to develop or maintain advanced methods of operational risk data collection and analysis. Therefore we are on the opinion, that AMA method should be still allowed, upon regulator's approval. It seems that the change of approach (SMA) can cause a significant increase of the operational risk capital requirements and have impact on the reduction of business activity and lending - in our opinion calibration factors (included in the formulas in p. 23, 27 , 31 and 35) for each component were probably adapted to large globally active banks. "One-size-fits-all" solution is not bearing on the adequacy of the requirements and scale of operational risk in medium and small banks, operating locally (in the country), and is at odds with the principle of

proportionality and does not differentiate these institutions. And the problem is, that although the Committee proposes solutions for large international banks, all banks in the European Union will have to implement these requirements.

In the proposal there is also no 'forward looking' element, like scenario analysis or external data. Static configuration: numbers are based on particular historic data. In our opinion this approach is not appropriate.

Detailed responses:

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

1. The risk sensitivity of the proposed approach, when compared to AMA, is limited especially for banks with lower BI. For a bank with BI at 2 bn EUR the capital requirement in case of:
 - a. no losses in the past would be at 190 mln EUR.
 - b. average yearly losses at 20% of business component would be in the range between 280 mln EUR and 336 mln EUR.¹.

The difference would amount to circa 50% which is low for such huge discrepancy in risk profile. In real world the differences will be even lower, as banks do not differ that much in their loss history. It will be also even smaller for banks with lower BI (for example 30% for banks with BI at 1.5 bn EUR).

2. By ignoring the internal loss multiplier for banks with BI below 1 bn EUR the proposed approach assumes, that they do not have high quality data on historical operational risk losses which is not true in many cases. There are small banks that have good quality operational loss databases. Similarly there might be bigger banks that do not have them. In our opinion the internal loss multiplier should be accounted always, when a bank can prove adequate quality of its loss data. Otherwise it should be replaced by some conservative, predefined multiplier if bank does not have high quality historical loss data (for example by loss multiplier calibrated at some high percentile of multipliers of reporting banks). This would also make SMA more risk sensitive for smaller banks.
3. By relying only on historical losses and BI, the method is retrospective in nature and is not able to reflect changes in operational risk profile. Similarly it is not able to take into account operational risk mitigation instruments such as insurance.

¹ Depending on the proportion of losses above 10 mln EUR. No losses above 100 mln EUR assumed.

NIM, CAP 3,5%

“Linear normalisation ratio for high-margin banks, defined as those with NIM larger than 3,5%, is adopted. Under this approach, the BI's interest component is adjusted by the ratio of the NIM cap, set to 3,5%, to the actual NIM” (16c. and 19).

1. The value of 3,5% and its application in the formula BI assumes economies in low interest rates environment. In the case of increasing interest rates, the assumption will not work as CAP, but as a FLOOR, which will contradict the assumptions (pt. 19 of Consultancy Document). In our opinion such an approach could not be appropriate.
2. Introduction of 3,5% value does not differentiate countries outside the euro zone due to monetary policy (low or high interest rates)
3. There is a doubt, if the assumption of high capitalisation of banks with high NIM is correct and constant. It should be verified to confirm the intention of proposed solution (similarly with the assumption of banks "with high revenues and expenses")
4. The coefficients like 0,5 uBI and 0,1 are not confirmed by statistical analysis. Also the coefficient level 3,5% as a proxy for interest income is not justified by statistical data. Please note that FI and FE are not explained in the List of Abbreviations (table 1), only in the main text body. The logics behind the structure itself and differences to the current Gross Income concept seem convincing.
5. Nevertheless the concept that operational risk level is a function of profitability components rather than direct size, number, severity and frequency of operations – creates doubts. AMA concept covered these factors much better than SMA.

BI (par 23)

1. “component in the formula: $\text{Max}(\text{OOIavg}; \text{OOEavg})$ ” – In our opinion it is not appropriate when loss appears to be treated (penalised) as much as profit: e.g. $\text{Max}(\text{Income}, \text{Expenses})$ in our opinion this approach is not appropriate.
2. On p. 5 there is no explanation of abbreviations: FI, FE in the table 1.
3. On p. 5 in the formulas of SC and uBI should be the absolute value of OOE and FE in the component with maximum, ie. $\text{Max}(\text{OOI}; \text{Abs}(\text{OOE}))$, $\text{Max}(\text{FI}; \text{Abs}(\text{FE}))$.

Answering 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”.

The concept of loss data inclusion is simple and seems acceptable. Nevertheless coefficients like 7 and 5 as well as using of average losses instead of other losses measures - have no statistical justification. We don't understand why average total loss only including losses above 100 mln EUR multiplied by 5 and why is it not multiplied e.g. by 7 as other components are in this formula. The idea does not reflect any statistical loss distribution. Risk sensitiveness is reduced comparing to AMA. Therefore improving controls and risk management will have reduced impact on capital requirement, only via absolute losses amounts, not their more subtle characteristics.

Possible alternative concept: to incorporate simple loss distribution approach along with the EBA rules derived from AMA methodology. Loss Distribution with at least VaR_{90%} level seems to be more proper. Consideration upon simple LDA for data between 0 to €10 Million with already proposed multiplied high losses could be more risk sensitive approach than current version.

Since the Conduct Risk gained currently the particular focus of regulators, there should be considered separate Conduct Risk component reflecting size and complexity of the organization. Estimation should be based upon internal and external data weighted with bank assets.

Loss data component should be also possible to be used by Bucket 1 banks, to increase incentives for proper risk management.

Loss Component (par 31)

1. There is a need to clarify what are the reasons and criteria to assume €10 million and €100 million thresholds and is not clear if banks take into consideration losses above 10 mln EUR when they calculate average total loss ?.
2. It is unclear whether bank should use Gross Loss or Net Loss value of to specify value of 10 mln EUR threshold and 100 mln EUR threshold. On p. 7 after the formula of Internal Loss Multiplier we propose making a note that estimating total annual loss banks must adhere standards described in subsections 6.1. and 6.2. or at least adding that it's about gross loss amounts.

B. Loss adjustment (par 48)

It is not clear what influence does Loss Adjustment have on qualification of losses above threshold.

C. General criteria on loss data identification, collection and treatment (43. forth subitem)

“De-minimis gross loss threshold of 20 000€ is acceptable” - In our opinion, this threshold implicates that banks with lower threshold are penalised while banks with higher threshold are rewarded.

D. Grouped Losses (par. 44)

There is no definition of grouped losses and date which should be taken into consideration in the case of grouped losses.

Example 1. One event has losses accounted in 2012-2014. Should we present all losses as one loss in 2012?

Example 2. Related events have been discovered and their losses have been accounted in years 2010-2014. Should we present all losses of all events as one event loss in 2010?

It should be decided whether related operational risk events mean events that are connected (i.e. the same fraudster).

E. Gross loss, net loss and recovery definitions (par 6.2, 43.d and e.)

It needs to be clarified the definition of “Material losses” and “loss adjustments” more precisely. Also it is not clear if potential losses should be included in the SMA requirements.

F. Loss adjustment (par 45)

“Reference date” – should be explained how bank should classify the loss when e.g. prepares dataset for SMA calculations (losses from years 2006-2015) and accounted a loss of 11 mln in 2012 but also got reversal of provisions of 2 mln in 2014 and which value of loss should be taken in the dataset for year 2012 and 2014.

Another example: what if bank prepares data set for SMA calculations (losses from years 2006-2015) and accounted a loss of 11 mln in 2012 but also knows that get reversal of provisions of 2 mln in 2016 (out of range of dataset 2006-2015), how should bank classify this loss? Which value of loss should be taken in the dataset for year 2012 and 2015?

Answering Q3. “What are respondents’ views on this example of an alternative method to enhance the stability of the SMA methodology”

Still the alternative method has disadvantages in risk sensitivity if compared to AMA method.

Alternative formula of Internal Loss Multiplier

It is difficult to refer and assess the alternative formula of Internal Loss Multiplier, because the main factor of that formula is unknown (to be calibrated). There is an inflexion point in case the Loss Component is equal to $0,5 \cdot BI$ Component (i.e. if Loss Component $< 0,5 \cdot BI$ Component the alternative formula is less severe than formula presented in point 31, else Loss Component $> 0,5 \cdot BI$ the alternative formula is more severe than formula presented in point 31).

Consolidation (par.4., 37., 43.)

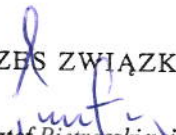
“SMA framework would be applied to internationally active banks on a consolidated basis” -

There are banks, dominates in national capital groups and for it are calculated AMA requirements and they have 10 year old data set history, while financial companies for which are calculated BIA requirements don't have 10 year old data set history. For these entities there is a problem how can be calculated the SMA requirement on a consolidated level.

Annex 1

In Annex 1 we suggest explaining in detail what IEA is, especially giving examples of typical sub-items.

Yours faithfully,

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