Standard Chartered

Working Group on Operational Risk (WGOR)
Basel Committee on Banking Supervision
Centralbahnplatz 2
Basel, Switzerland

6th January 2015

Dear Sirs,

Standard Chartered Bank (SCB) welcomes the opportunity to comment on the consultative document "Operational risk – Revisions to the simpler approaches" (BCBS291). The Bank is encouraged by the open set of disclosures around design, methods and models used to arrive at the recent proposal. The proposal recognises that operational risk profiles have changed. We find this is especially true with regards to the nature of losses in the tail of the loss distribution where supervisory fines have outpaced all other loss types. SCB supports the need for a refresh albeit we have two fundamental concerns.

The first is that modelling the tail of operational risk loss distributions to determine capital or RWA is at best a very remote proxy indicator of risk and at worst a highly misleading view of risk. This is especially true when high levels of confidence, beyond one standard deviation, are used in the tail of the distribution. Historical data analysis will yield more reliable results for the main body of the loss distribution and therefore a more reliable measure for Pillar 1 capital requirements. Judgment on the risk and control environment of a firm coupled with stress testing and scenario analysis have a more relevant part to play in the tail which is by nature random and difficult to impose a model on. This work would be the basis of the Pillar 2 dialogue between firms and their regulators.

The second concern is the role of capital and RWA in operational risk. As proposed there is no benefit in Pillar 1 from risk management as there is in credit and market risk. The only way to reduce the operational risk RWA allocation to a business would be to stop the business. Additionally the method models tail risk but does not allow for loss absorption - the RWA requirement will rise in the wake of losses and this is also potentially true in Resolution.

Given the above concerns we would recommend a more fundamental rethinking of the purpose of operational risk capital. We would recommend an approach to Pillar 1 that serves as a minimum charge for being in business, and a capital buffer as part of a Pillar 2 assessment that can be used to absorb losses and replenished. This buffer could be set by lead or local regulators with reference to risk and control indicators as well as stress and scenarios analyses.

Notwithstanding these concerns answers to the specific questions in the Consultation Documents are enclosed. We would be pleased to discuss any of these points further with the WGOR.

Yours faithfully,

Graeme Forrester
Group Head, Operational Risk

APPENDIX: Comments on the specific questions raised in the Consultation Paper

Q1: Are there any other weakness in the existing set of simple approaches that should be addressed by the WGOR?

The existing approaches use Gross Income (GI) as a proxy indicator for Operational Risk ("OR") exposure. This bears no relevance to the effectiveness of OR management or the OR profile of a bank. Also it does not take into account the inherent risk environment and how this differs in various markets.

The proposed simpler approach uses the Business Indicator (BI) and puts greater focus on a bank's financial figures with little incentive to manage operational risks better; i.e. the focus is on how much capital a bank should set aside given its financial position, not on how much capital a bank should set aside given its gross and residual risk profile.

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

The Revised Standardised Approach (RSA) is focused more on simplicity and comparability than risk sensitivity. Our observation is that the RSA is less risk sensitive than the TSA.

There are a number of different drivers for operational risk ranging from types of business to the internal control environment and risk management practices. Economic and regulatory environments also differ across the industry. Accordingly differences in operational risk among banks can vary considerably. Taking a simple approach to model risk with a single cohort based on size will not differentiate banks that are managing their risks well. Moreover, from a modelling standpoint, it is overly simplistic to assume homogeneity of risks across a banks entire business.

The practices adopted by banks for operational loss recognition are different and will continue to hinder comparability. For example, the treatment and recognition of boundary events can vary significantly across institutions. Given that losses feed into the BI the outcomes may not be comparable.

It is therefore our view that risk sensitivity is being sacrificed for simplicity and the end result is therefore not a meaningful measure to enable comparison across banks. The approach does not succeed in determining capital requirements that are risk sensitive.

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Q3: Are there any further improvements to the BI that should be considered by the WGOR?

While the proposed proxy indicator, the BI (a modification of the Gross Income Indicator under Basel II) has the effect of increasing capital requirements, it remains essentially an income-driven metric without any relevance to operational risk management. It can never be a suitable measure of operational risk in a bank albeit the WGOR asserts that there is some correlation between modelled losses (in the OpCar model) and the BI.

The inclusion of regulatory fines and penalties in the BI is in effect double counting and further reduces the investment capacity to remediate operational risks. If a Bank pays a fine in one year it will continue to raise capital requirements for the next three years.

A further challenge is that the BI introduces higher volatility in operational risk capital requirements than may have been intended. Operational losses such as fines and penalties and absolute value of trading income, typically more volatile components, are now additive in the BI. Large, infrequent OR losses (such as fines and penalties) will lead to jumps in capital as they phase in or out of the three year averaging window. This will amplify capital volatility.

Further consideration could be given to:

a) Internal indicators of risk and control in a Bank such as key control indicators (KCI) or key risk indicators (KRI).
b) External factors and inherent risks
c) Economic indicators in cases where there is empirical data suggesting that operational losses (such as fraud) increase in times of financial stress.
d) More concrete guidelines for recognition and classification of operational losses and near misses to facilitate consistency and comparability across banks.

Further clarity is required regarding the following:

e) Rationale for the exclusion of insurance income and expenses from the BI. Several banks sell insurance related investment products which is potentially a source of mis-selling risk and seems to draw favourable treatment under this approach.
f) Rationale for the inclusion of income *and* expenses of leasing in the BI. The income and expense from leasing and other fee-based businesses are summed up which is inconsistent with other business lines.

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

A comparison of RSA against the capital determined by banks using approved AMA models could be disclosed to further understand the appropriateness of modelled capital requirements. In the longer term it might be beneficial to look at other indicators rather than size (including indicators of loss, risk and control) over a longer timeframe to determine whether a more risk sensitive approach is feasible.

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?

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We stress that size-based buckets are not the main indicator of the operational risk profile of a bank. Having said that, 5 buckets appear to be too few and will not reflect the vast variations in bank size and business models across different markets.

From an implementation perspective, the *number of BI buckets* is not a major obstacle. Most systems can accommodate any number of buckets. The focus should be more on "capturing difference in operational risk profile". To answer the question more fully, we would need to see the determinants of the buckets and the corresponding coefficients.

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

The replacement of the business line segmentation, with 'size' based segmentation irrespective of business line is a fundamental change in the approach. While the Bank can see that size based segmentation at an Industry level supports the WGOR's observation that the current approach 'is on average undercalibrated, especially for large and complex banks,...' it does not sufficiently meet the objectives of risk sensitivity at an individual bank level. In fact, the removal of the business line segments will result in a less risk sensitive operational risk capital approach and will further isolate capital requirements from operational risk management. The proposal does not provide evidence to conclusively show that business line indicators are not adequate differentiators of operational risk. Nor does it show that size is a better differentiator of operational risk than business line.

The WGOR in effect assumes (by removing the business line segmentation) that losses are modelled by a single cohort and hence all losses across a bank are homogeneous and independent. This is an overly simplistic modelling assumption.

Consideration could be given to models which retain business lines by measures of size as a way to combine the WGORs recent observations and the overarching objective to link capital requirements with risk sensitivity.

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

It is unclear how to apply the model to a subsidiarised organisation. The RSA model is non-linear function of the BI. Hence the capital calculation applied to each subsidiary individually will sum up to less than the capital calculated for the Group as a whole. Allocation and the accountability for OR capital will become a challenge for banks to manage. The removal of business lines further compounds this issue.

The BI will also be relatively more complex to implement than the current gross income approach and at the same time does not establish closer correlation with operational risk. The revised approach calls for more granularity in data and data history than has previously been captured (with reference to the exclusions mentioned in Annex A). Gross Income, as used in the TSA approach, aligns more closely to financial reporting and is therefore easier to implement.

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

This question recognizes the role played by business lines in operational risk assessment and could also be considered.

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

Capital requirements that are linked to the level of risk are the biggest incentive for banks to promote rigorous operational risk management internally and extend best practices across the industry. The BI could be improved through offsetting investment in controls related to improved operational risk management and the exclusion of fines of penalties and insurance re-imbursements. However the model still suffers from inherent weaknesses associated with the use of historical loss data in operational risk. SCB would therefore prefer to maintain a simpler method (such as TSA) or a truly risk sensitive model which is based on the indicators of control in an institution.

Further clarification required

Further information is required regarding the expected timeline for the roll-out of this or any revised approach. Banks would require sufficient time to source additional data requirements over the prior three years to produce an accurate measure of capital.

Further information on how often a re-calibration exercise would be undertaken by the WGOR would also be helpful. Significant and frequent re-calibrations would impact capital planning and increase capital volatility.

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