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Secretariat
Basel Committee on Banking Supervision
Bank for International Settlements
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Attention:

Dear Sir/Madam

Comment on the BCBS Consultative Document Operational risk – Revisions to the simpler approaches

We support the work done by the Basel Committee's Working Group on Operational Risk and welcome the release of the consultative document on the revisions to simpler approaches for operational risk.

We shall address each question in turn.

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

The most significant weakness in the current approach relates to the increasing capital requirement as gross income increases, whilst the operational risk exposure does not necessarily increase in the same ratio. This approach does not consider the maturity of the organisation's risk management.

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

A single standardised approach should allow for increased comparability across banks as there will only be one operational risk capital requirement under the simpler approach to compare and interpret across banks.

However, the revisions are heavily slanted to capital management and there is a risk that the importance of day-to-day risk management and the incorporation of appropriate operational risk sensitivities may be diluted in this process. Banking is complex and the pursuit of simplicity and comparability, although desirable, should not be prioritised over sound risk practices. The emergence of risk management as a key risk discipline post the financial crisis, has provided much needed management support for the further development of this risk discipline.

The appropriate balance is difficult to achieve on a global scale and the BCBS could assist with its objective to improve the usefulness of this information to the end user, by determining who the targeted end user would be, to ensure that it is fit for purpose.

Question 3: *<u>Are there any further improvements to the BI that should be considered by the Committee?</u>*

Review mechanisms

One of the weaknesses of the existing standardized approach for operational risk is that there is no established framework to review its calibration. This is recognized in the consultative document which states that

> "*…no rigorous review has been made of the effectiveness of GI (or other potential indicators) as the proxy for the operational risk exposure of a bank and the adequacy of the calibration of the regulatory coefficients of the BIA and TSA*".

However, there is no mention in the document if the proposed revised standardized approach would be subject to regular review. Such regular review is necessary to make sure the revised standardized approach remains reflective of banks' actual risk profiles. Consideration should be given to providing appropriate review mechanisms to ensure that loss data characteristics across jurisdictions are appropriately incorporated.

Business models

The Business Indicator (BI) is driven by income statement components that appear to underpin the size and magnitude of a bank's operations. This is intuitively appropriate for the rudimentary measuring of operational risk capital requirements.

Consideration of the structure of a bank's business model may require further deliberation, particularly if a bank has a large "services component" and whether it is appropriate to compare it to a bank which is dominated by a large "financial component" when both have a similar BI. The question arises as to whether the BCBS regards the capital requirements for a bank whose business operations primarily result in fee income as equivalent to a bank whose operations primarily result in trading profit.

Furthermore, banks operating in high fee income regions are penalised more than banks operating in low fee income regions. Our view is that fee income is a relatively safe form of income and hence operational risk associated with it should be low. In South Africa, interest income is a significant contributor to revenue. The business indicator penalises banks with high interest income, however regions where interest rates are low may not recognise this as a concern.

The previous TSA tried to address some of these concerns in part by promoting business lines and beta factors, which we acknowledge could introduce the risk of mapping products and services to the incorrect business line, an onerous task in any bank and a risk that regulators and auditors would need to consider when discharging their obligations.

A potential solution to this could be to identify acceptable bands or levels for each component. If the component exceeds the band or level, an adjustment is made, i.e. if a services component is greater than say 50% of the total BI then the BI is adjusted by a factor of X or if the financial component is greater than 60% of the BI it is adjusted by a similar factor of Y.

The proxy for future losses

The development of the quantitative OpCaR model is based on each bank's internal loss data. Internal loss data is by its very nature, backward looking and is not the best proxy for future losses, as confirmed in the introduction of the executive summary:

> "*In addition, the changing operational risk profiles of banks may render a calibration based on the past behaviour of variables unfit for the future*."

It is common practice e.g. for the control environment to be strengthened to prevent the recurrence of similar losses. We do recognise the challenges of including scenarios as well as business environment and internal control factors (BEICFs) in OpCaR. However, if the sole basis for operational risk capital is historical loss experience, we believe it underscores the need for a regular review of the revised standardized approach's calibration.

Paragraph 7 of Annexure 2 notes that the OpCaR methodology does not include information relating to scenario analysis and BEICFs, and that exclusion of these elements may cause, in some cases, an underestimation of the OpCaR figures. Hence, it was decided to use a more conservative class of severity distributions in the OpCaR calculator.

However, it could also be the case that by excluding those same factors, OpCaR figures are overestimated. In addition, operational risk mitigants are not taken into account. Thus, we do not see the need to use conservative severity distribution assumptions in OpCaR.

Pillar 2
Annexure 4 provides an example of guidance regarding qualitative standards that should be observed by large internationally active banks under Pillar 2. It is not clear why there should be separate guidance, rather than just a reference to the Principles for the Sound Management of Operational Risk. Also, it is not clear what "under Pillar 2" means, if a bank fails to meet the standards would it be subject to an additional capital charge?

Mapping
Annexure 4, Section B, item 6 requires banks to include a mapping and reporting of gross income and loss experience by business line or activity. It is not clear why these are still necessary when gross income and business lines are no longer used in the proposed new TSA.

Absolute values
In Paragraph 13, both the interest component and financial component of the Business Indicator require absolute values. We would propose that the absolute value be extended to the services component to address the potential for netting (deductions) arising from different accounting treatments that could, in certain circumstances result in e.g. negative fee income in a particular year.

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

Calibration
In developing the new simple approach, the adequacy of operational risk capital requirement for banks was primarily assessed and analysed based on the 2010 QIS exercise. To ensure consistency with the 2010 data set, the appropriateness of the

new proposed simpler approach and the resulting operational risk capital levels should be calibrated against the 2014 QIS exercise. The 2014 QIS data covers a longer time period than the 2010 QIS and the OpCaR model should be rerun. The results and deductions made from the 2010 QIS, pertaining to buckets and regulatory coefficients should be compared to that of the 2014 QIS to perform a validation of these proposals as provided for in the consultative paper.

In addition, we would propose that a sample of bank's operational risk capital requirements should be taken across geographies, to assess the effect of the new proposed simpler approach against that of the current simpler approaches at a country level (demonstrating economies of scale). For example, where banks in emerging markets have small BI's when compared to comparative banks in developed markets with large BI's, would it make sense to have a differing percentage of operational risk capital requirements?

Domestically, both of these banks are of similar importance to the respective domestic financial system (domestic systemically important bank). It may be that banks with larger BI's in developed markets play a more significant role in the wellness of the global financial system, however, should the BCBS not also consider the effect on that country's financial system?

Migration to advance approaches
Banks may use more advanced operational risk methodologies for their in-house management of operational risk and continue to report on the standardised approaches. The incentive to migrate to AMA reporting stems from the recognition of improved risk management practices by the regulator and the reliance that the regulator can place on these advanced approaches is compensated with a lower capital requirement, reflecting a more accurate translation of the riskiness of the bank into capital. The reduction in capital may encourage banks of their own accord, to make the substantial investment required in operational risk systems and personnel.

The existing TSA framework therefore generates a capital requirement that is higher than AMA. However, regulators have national discretion to prescribe a minimum floor to the AMA capital benefit as applied in South Africa, which then limits the benefit derived from using AMA. The refinement of the proxy indicator will intentionally increase the capital impact of the new TSA which will directly translate into higher disallowance of AMA benefit and further reduce the incentive to migrate naturally to AMA.

We would propose that the BCBS reflect on providing guidance on national discretion that will ensure the AMA will continue to generate economic benefits commensurate with the investment in and promotion of the advanced approaches.

Research
As the operational risk discipline grows in importance, we would promote an ongoing commitment by the BCBS to research, review and analyse the latest developments in operational risk to ensure that the private initiatives of the industry, to enhance operational risk practices, remain relevant. Best practices in risk management should become the driver of behaviour rather than the pursuit of lower capital levels.

Question 5: *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?*

Euro equivalence
Specifying the buckets in Euro introduces an additional risk that currency volatility will now influence operational risk capital requirements. This is not the case with the existing simpler approaches to operational risk. For stable currencies, this is less of an issue, however, for banks in emerging markets where the local currency is extremely volatile it will cause fluctuations in operational risk requirements based solely on the movement of exchange rates.

As an example when the local currency (ZAR) strengthens against the Euro, banks will be required to hold more operational risk capital and the average coefficient (beta) across buckets increases. This appears to be counterintuitive.

The introduction of exchange rates as a driver of operational risk capital may require global co-ordination between regulators to ensure that all banks with exposures to Basel jurisdiction apply the same exchange rate. It may be prudent for the BCBS to publish a table of appropriate exchange rates to use, for anchoring the lookup of capital coefficients for the range of currencies that apply in the different jurisdiction that subscribe to the Basel Accord.

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

Coefficients
Basel introduces a set of escalating coefficients from, 10% to 30%, based on the size of the bank that results in larger banks holding more capital. In addition, the method seems to penalises banks where there are multiple entities operating in one group.

Business lines
Will the BCBS promote further research on business line specific operational risk characteristics?

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

At this early stage, the introduction of the layered approach does not seem to introduce complex implementation challenges however, over time the BCBS will need to ensure that jurisdictional idiosyncrasies are appropriately considered and managed.

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?*

Following on from our comments in question 3 under the heading business models, where we address both scenarios, we would support this proposal. Failing to address e.g. the disproportionately high capital applicable to banks that are highly specialised with fee income businesses, might lead to a form of arbitrage, whereby fee structures are reconsidered.

Depending on the outcome of the analysis of the data from the 2014 QIS, it may be appropriate, to allow banks that are highly specialised in fee businesses to adjust the BI calculation above certain levels.

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

The standard setting bodies have responded to the G20 and FSB by producing an unprecedented series of banking and broader financial reforms. In South Africa, bank management recognises the importance of operational risk and the introduction of higher capital requirements for operational risk is well positioned, despite the many new regulatory requirements that compete for both management time and bank resources. The large South African commercial banks adopted AMA from 2008, with the implementation of Basel II.

The need to translate into appropriate action, within such a rapidly changing environment, operational risk managers would benefit enormously from BCBS guidance, based on quantitative and qualitative analysis of the range of available practices.

Certainty in this regard, could aid in driving convergence to the minimum standards for operational risk management practices, corporate governance and appropriate incentive frameworks that in the process would avoid misinterpretation, the wasting of resources and ensure more consistent risk management practices across the industry.

Competition between banks and the moral suasion of regulators will only serve to increase the desire to comply. In the absence of tangible minimum standards the natural evolution to a higher AMA standard of operational risk may be constrained.

In addition, the regulators would benefit from agreed reporting definitions that would standardise the information collected on operational risk from the banks.

In concluding, we hope that our comments offer sufficient substance for the BCBS to continue its work in the area of operational risk and we thank you for the opportunity to participate in this process.

Should you require any further information, please do not hesitate to contact me.

Yours faithfully

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