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By email: baselcommittee@bis.org

Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

Dear Sirs

Consultative Document on Operational risk – Revisions to the simpler approaches (October 2014)

We refer to the consultative document on the "Operational risk – Revisions to the simpler approaches" issued by the Basel Committee on Banking Supervision (BCBS) in October 2014. On behalf of our members, we set out in the annex our detailed comments on the proposals in the consultative document.

We hope you would find our comments useful. For any questions, please do not hesitate to contact Ms Emily Ngan of the Secretariat at (852) 2526 6080.

Yours faithfully

Eva Wong
Secretary

Enc.

c.c. Ms Karen Kemp, Executive Director (Banking Policy), Hong Kong Monetary Authority

<u>Annex: HKAB's Comments on BCBS's Consultative Document on Operational risk – Revisions to the simpler approaches (October 2014)</u>

I. General comments and recommendations

We support the BCBS's efforts to address the shortcomings of the current simpler approaches. However we are concerned on the following issues and the reasons for our concerns are laid out below followed with pragmatic suggestions for the BCBS to consider in the next stage.

1. The replacement of the business line segments with "Size" based segments

a) A most critical change in the proposal is the replacement of the business line segmentation, with a "Size" based segmentation irrespective of business line. However, the BCBS does not provide the evidence that conclusively shows the business line indicators are not adequate differentiators of operational risk or even that size is a better differentiator of operational risk than business lines. The assessment on page 11-12 (paragraph 30-32) does not seem well supported. We believe that business lines still represent a meaningful driver for risk, but they may need some recalibration. In fact, the removal of the business lines segments will result in a less risk sensitive operational risk capital approach and will further isolate capital calculation from operational risk management for individual banks.

b) Q8 on page 16 of the Consultation Paper recognised that a high concentration of fee based activities will lead to disproportionally higher capital requirements and with the converse problem for low interest margin businesses hence acknowledging that business lines are a differentiator of operational losses.

c) It is unclear whether the revised Standardised Approach ("SA") should be calculated top down or bottom up. A top down calculation would result in a higher consolidated capital requirement than if the calculation was undertaken at legal entity level and summed. The model is non-linear function of the Business Indicator ("BI") hence the calculation for capital applied to each subsidiary individually will sum up to less than the capital calculated for the Group as a whole. Together with the removal of business lines, it will make allocation and accountability for capital a bigger challenge for banks to manage.

2. **The use of Business Indicator rather than Gross Income has several challenges and shortcomings**

   a) While the proposed BI [a modification of the Gross Income ("GI") 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.

   b) BI introduces higher volatility in operational risk capital estimation than was probably intended by the BCBS. For example, the addition of operational losses such as fines and penalties, the absolute value of the netting of expenses would in general increase the volatility of operation risk capital requirements. Fines and penalties are typically large infrequent losses which will lead to jumps in capital as these costs phase in or out of the three years averaging window and have the unintended consequence of amplifying capital volatility.

   c) The metric will also be relatively more complex to implement than the current GI approach, without establishing significantly closer correlation with operational risk. The revised SA calls for more granularity in data reporting as compared to financial requirements taking into account the exclusions mentioned in Annex 1. GI, with netting of different components was easier to implement.

   d) Paragraph 81 (Page 20) of the BCBS paper on "Operational Risk Supervisory Guidelines for the Advanced Measurement Approaches" acknowledges that absence of definitions in the Basel II text for "gross loss" or "recoveries" and varying loss data collection practices among AMA banks results in differences in the loss amounts recorded for similar events. It is not unreasonable to assume that non-AMA banks would face similar issues and would have variations in recognition of operational loss. There is therefore an issue of comparability and transparency to be covered in the final recommendations of the BCBS, which should lie outside the calculation of the operational risk capital.

3. The approach does not provide incentives for improving risk management

a) The inclusion of fines or penalties into the capital calculation as a component of operational losses, could lead to a circular charges as both are regulatory imposed. The bank would pay a large fine in year 1 and also bear reduced retained earnings and additional capital against these fines for the next 3 years. The regulatory impact would be deeper than intended and carried over a longer period and does not recognise investment in remediation of operational risk that would bring down operational risk exposures. It may also have the unintended consequence of reducing scale and scope of business which will amplify the business cycle.

b) Further, the exclusion of insurance reimbursements (as offset to operational losses) means that banks are not incentivised for taking mitigation action. The approach in general provides very little incentive for banks to take steps to manage the underlying risks better. The BCBS should consider mechanism to adjust the BI downwards where banks are taking steps to remediate or have in place comparatively better operational risk management practices. This could be in the form of, for example, deductions for risk management costs.

4. The approach is neither forward looking nor risk sensitive

a) The method is based on 3 year historical averages of incomes and expenses and the calibration is based on historical data over 5 years. Hence the approach is not forward looking.

b) The use of a financial indicator can never be a suitable measure of operational risks of a bank – albeit, the BCBS asserts that there exists some correlation between modelled losses [the Operational risk Capital-at-Risk ("OpCaR") model] and financial indicators. This bears no relevance to the effectiveness of the operational risk management, or the operational risk profile of the individual bank. Neither does it take into account the external control environment such as industry practices and regulatory requirements and improvements or deterioration in either. The proposed revised SA simply puts greater focus on a bank's financial figures with very little incentives within the approach to manage operational risks better.

c) The internal control environments of banks could vary significantly, resulting from different processes, systems, training of staff (including knowledge, skills and mindsets) that each bank adopts. There is neither consideration for different risk management practices that exist in the industry nor are banks incentivised by this approach to improve their operational risk management.

d) The use of a single cohort (rather than business line segmentation or some other segmentation) reduces the risk sensitivity of the approach at an individual bank level – see also point 1(a). It is therefore our view that the comparability afforded by using a simple indicator across the industry is not meaningful from an operational risk management perspective or for the purposes of holding capital that is risk sensitive.

5. **The BCBS has disclosed significantly more information on how they designed and calibrated their models, however, the rigour of the models and disclosures still falls short of expectations.**

a) There is a concern that the models would not in fact satisfy the validation standards that banks have adopted as part of regulatory requirements. The BCBS should disclose more information on the calibration, statistical test results and any validations done prior to publishing the Consultation Paper to assure banks, that the standards applied are adequate for a critical model with worldwide implications.

b) Other areas of concern in the calibration approach include the modelling of aggregated loss points rather than the fitting of the entire loss data set and the number of banks where the modelling process did not work. It is important that sound modelling practice is used to calibrate the capital requirements for a majority of the banking industry, which will be using the revised SA.

c) The BCBS 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 assumption.

d) The OpCaR methodology does not include information relating to scenario analysis and the banks internal control environment. These may either under/over estimate the capital requirements hence the decision to use a conservative Severity model assumption is unsubstantiated. In addition, operational risk mitigants are not taken into account.

6. Further clarification required

a) Further clarification is required as to whether any Pillar 2 capital add-ons for operational risk will still be applicable once the revised SA is rolled out. The capital add-ons are determined relative to base capital requirements of the Standardised Approach ("TSA"). A change in the base capital approach would necessitate a review of the capital add-on.

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

c) Further information is required on how often a re-calibration exercise would be undertaken by the BCBS taking into account that significant re-calibrations, very frequently would destabilise capital planning and capital volatility.

7. Recommendations for the BCBS in the next stage of revisions

a) We would welcome an approach that does not deviate significantly from the current but with a re-calibration to more recent data. The BCBS is requested to consider the maintenance of business lines as a first step to aid risk differentiation.

b) Secondly, the principle to enable a forward looking measure is difficult to implement from a modelling perspective and to be standardised sufficiently that it remains applicable across geographies and institutions. The BCBS is therefore requested to consider other mechanism to ensure banks making improvements in their risk management are rewarded either through components in the proxy indicator or through haircuts. The BCBS should ensure that such components are objective and easily replicated across the industry.

II. Comments on the specific questions raised in the Consultation Paper and recommendations

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

The existing approaches use GI as a proxy indicator for operational risk exposure. This bears no sensitivity to the effectiveness of the operational risk management, or the operational risk profile of the individual bank. Neither does it take into account the internal control environment and external control environment such as industry practices and regulatory requirements.

The revised SA puts greater focus on a bank's financial figures with very little incentives within the approach to manage operational risks better, i.e. how much capital a bank could set aside given its financial position, but less on how much capital a bank should set aside given its risk profile.

The existing and proposed approaches ignore the risk mitigation actions done by the banks and provide no incentive to banks to reduce the operational risk.

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

a) A single standardised approach does provide simplicity.
b) In terms of comparability, it measures using a common indicator, either GI or BI.
c) However, this does not help to differentiate the risk sensitivity of individual banks. The differences in operational risk management and internal control between banks can vary considerably. For example,
   i. The internal control environments of banks could have huge variations, resulting from the different processes, systems, training of staff (including knowledge, skills and mindsets) that each bank adopts. There is neither consideration for different risk management practices that exist in the industry nor are banks incentivised by the revised SA to improve their operational risk management.
   ii. The practices of operational loss recognition of banks are different. For example, a refund to a customer suffering investment loss could be

considered compensation (operational loss, e.g. unsuitability, improper practice and product flaws) or goodwill (contra revenue, e.g. maintenance of customer relationship without admitting any fault). (Please also refer to paragraph 2(d))

iii. It is therefore our view that the comparability afforded by using a simple indicator across the industry is not meaningful from an operational risk management perspective or for the purposes of holding capital that is risk sensitive.

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

a) We would like to understand the rationale why insurance income and expenses are excluded from the BI.
b) We would like to understand the rationale why both income and expenses of leasing are included in the BI (double-counting just on leasing business).
c) We consider that the proposal of taking absolute value of net financial profit and loss might lead to double counting of capital charge as the capital charge on negative financial profit and loss would already be reflected in the reduced capital base.
d) We consider some external factors can be taken into account such as local regulatory requirements, industry controls / practices. In case where there is empirical data suggesting that operational losses increase when financial crisis sets in, should economic indicators be part of the proxy indicator?
e) We consider that the insurance costs covering operating losses should be taken into account in adjusting down the BI in order to reflect mitigations that a bank made in terms of operational risk.
f) Also, we consider the investment of a bank in process and system improvements is particularly important for preventing frauds (internal and external) which we are seeing increasing trend in the past years. This can also be taken into consideration.
g) In addition, more concrete guidelines for recognition and classification of operational loss and near miss should be given. It is to facilitate maintenance of consistency / comparability across banks.
h) Operational losses are embedded on both sides of the calibration equation, i.e. within the OpCaR model and also within the BI, but over different periods (OpCaR model is based on losses over 5 years whereas BI is based

on operational losses over 3 years). The BCBS should consider whether this approach will breach the underlying modelling assumptions.

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

The BCBS should continue to assess the adequacy of operational risk capital versus the historical operational loss data to determine the appropriateness (excessive or shortage). The BCBS is requested to work together with industry bodies and banks in a collegiate fashion to revise the proposals.

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?

a) We maintain our view that the size-based bucket is not the only or indeed the most significant indicator of the operational risk profiles of the banks.
b) Having said that, we consider 5 buckets are too few. There could be more size-based buckets in between the 3,000 – 30,000 tier with a lower step-up of coefficient. We consider a 10-tier scale should be more helpful to differentiate different size of the banks.
c) We would also like to know more about the determinants of the bucket tiering and the corresponding coefficients.

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

We consider business lines have different risk dynamics on operational risk exposure, not varying according to the GI, but in terms of operational scale and related controls. Thus we consider business lines are relevant in determining operational risk profile. The irrelevance of business lines has not been adequately proved by the Consultation Paper.

We also consider the use of a single cohort to model operational losses as being overly simplistic as some level of segmentation is required to ensure that conditions of homogeneity are preserved to some degree.

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

While a simple approach, the proposal will be more onerous to implement given that additional data requirements as laid out in the inclusions and exclusions of Annex 2. Some data items may not be readily available in current system set-up such as the separation of insurance reimbursements from operational loss recoveries.

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 believe the BCBS should further investigate this issue during the next stage of calibration.

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

If there is capital relief on banks with better operational risk management, this is the biggest incentive for banks to promote rigorous operational risk management internally and extend best practices across the industry. In practical term, if investment expenses related to operational risk management can be excluded from the proxy indicator, this will provide incentive for banks to enhance their operational risk management.