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Response to consultation paper: BCBS 291 Operational risk - revision to the simpler approaches

Dear Basel Committee on Banking Supervision,

The Institute of Operational Risk, an Institute comprising more than 500 operational risk professionals from over 20 countries world-wide, welcomes the opportunity to respond to the Basel Committee on Banking Supervision's consultative document, 'Operational risk - revision to the simpler approaches'.

General comments

There is no easy solution to calculating operational risk capital. The formulae used for the simpler approaches in Basel II, based as they were on income attributed to business lines (profit, but not cost, centres) were always designed to be a crude proxy for estimates of operational risk capital. They lacked any general validity and therefore credibility in terms of being risk sensitive proxies for operational risk. However, what they lacked in risk sensitivity, they more than made up in simplicity and as such they served an important purpose as a simple to implement approach for firms not sophisticated enough to be on AMA (and for some as a stepping stone to the more sophisticated AMA approach). The proposed approach, which resolves the income component to General Income and adds a further component relating to a firm's size, adds little, in our view, either to validity or credibility, yet introduces additional complexity and potentially significant costs of compliance to implement the new approach. We believe that policy makers and supervisors should focus their efforts on raising the standards of operational risk management within the industry, rather than focusing on changing the maths.

If the Committee's underlying intention is to increase the levels of regulatory capital allocated to operational risk within large international banks (since as it states, the existing simpler approaches have resulted in insufficient capital being allocated to operational risk), it could have done this by simply increasing the alpha/betas in the existing approaches. The existing BIA/ TSA approaches are more than adequate for the majority of smaller and less complex firms, and for more sophisticated firms who have decided not to adopt AMA, many national supervisors already require them to conduct modelling/ more sophisticated analysis as part of their Pillar 2 assessment and require additional capital as a result, so the fact that the pillar 1 calculation is rudimentary and not risk sensitive is immaterial. For the largest most complex firms, policy makers and supervisors should require the adoption of AMA.

At a fundamental level, attempting to *'correctly* estimate the operational risk capital requirement' (Introduction, page 1) is probably an exercise doomed to failure, even for internationally active banks using the AMA. It is only through an effective Pillar 2 ICAAP process that the appropriateness of the operational risk capital allocation can be determined and the Committee should focus attention on this process, rather than on an ultimately spurious mathematical formulae.

Operational risk encompasses failures of conduct and risk culture as well as events as various as cyber attacks, process errors, technology failures, third party dependency failures (including infrastructure or supply chains) and natural disasters such as tsunamis and hurricanes. At the tail, each of these events can be catastrophic as well as being entirely idiosyncratic. Happily there are few of them statistically, especially in certain operational loss event categories, but that scarcity is another reason why we consider that using the impacts of past events is a poor basis for 'correct' estimates of operational risk capital. If operational risk capital is to be estimated with any confidence it should relate to cause, rather than effects or impacts and be forward-looking. It would have been helpful if the Committee had discussed this approach to modelling.

To extrapolate the data to calculate a standardised measure which is to cover many thousands of banks which are not only different in size but different in their risk culture, risk appetite, control environment and business mix is also an exercise which will simply become a mathematical exercise which diminishes operational risk management per se and will continue to lack credibility. It is likely that the revised approach will do little to raise standards of operational risk management, but simply lead to a comparison between the new standardised result and the result under the AMA and banks will decide whether it is worth their while to adopt the AMA and its attendant incremental and substantial costs or accept a flawed standardised formula.

As the paper points out (paragraph 47), operational risk capital is no substitute for effective controls and operational risk management from the board right down to the processing level. Indeed, operational risk management, being inherent in 'all banking products, activities, processes and systems' (Sound Practices paper 2011), should be at the heart of enterprise-wide risk management. The revised approach continues to downgrade its importance. Whilst it is true that regulatory standards of operational risk management for banks using the Standardised Approach will not be lower, there appears to be little regulatory expectation that they should be improved, including through a more robust Pillar 2 ICAAP assessment.

Although we can understand why scenario analysis would be difficult to use as a standardised approach, it would have been helpful for the Committee to have offered further analysis of its benefits and encourage its use. Scenario analysis is forward-looking, enables firms to try to identify and understand the impact of low frequency, high impact events, necessitates the involvement of experts around the firm, involves independent peer review and challenge and engages senior management in the results.

There is one final point which is rarely touched on in regulatory discourse and that relates to the definition of operational risk. The original authors of the regulatory definition (see *Operational Risk: the New Frontier* (RMA,1999),which followed a survey of international banks by the BBA, ISDA and RMA) were conscious that their causal definition was to be a 'positive' definition, rather than the one which was prevalent at the time that operational risk was 'anything other than credit or market risk'. Operational risk probably covers approximately 70 - 80% of credit and market risk. Although the regulatory definition is generally adopted by banks, as evidenced in their reports and accounts, the Basel II capital regime has effectively driven down operational risk to being 'anything other than credit, market and liquidity risks'. Different firms have different treatments of the boundary between operational risk and other risks, from both a capital and management point of view. The Committee's paper would have benefited from consideration of this important point, which also casts doubt on the data set used by the Committee in its calibrations.

Whilst as stated above, we do not believe the BCBS should be focusing on revising the maths in the simpler approaches but instead on the raising the standards of operational risk management, we have considered the proposals on their merits and make comments on how they could be improved.

Detailed comments

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

The existing approaches are, as the Committee points out, pro-cyclical. As far as we can see, the proposed revision does little to alleviate this important weakness. Any revision should aim for a ‘through the cycle’ approach, as with the approach to credit risk.

At a technical level, the basis of the revised approach appears to take little recognition of the fact that operational risk failures, as with general insurance, can take years to become apparent. It also does not resolve the problem of how to use data derived from multiple events which may have an apparent common cause, for example PPI mis-selling in the UK. Should these be treated as a single event stretching over a number of years, even though the root causes may not, on investigation, be identical? Should regulatory fines or other sanctions be treated as a single event or spread over the life of the operational risk event and over the individual events to which they give rise? On the other hand, related to the well-known major cases emerging from the banking crisis, there is the question of litigation costs. It would be reasonable for deductions to be made to capital where these costs have been provided for by banks.

In addition, in relation to operational risk event data, reporting of losses is an imperfect exercise, to say the least; reporting of gains, which often are caused by operational risk failures, is relatively non-existent; the idiosyncratic nature and distribution of large tail events; our general comment about the boundary issue; all of these factors throw serious doubt on the quality of the database against which the Committee is calibrating the revised approach.

At a more fundamental level, as outlined above, the weaknesses of the revised approach will continue to lead to firms undertaking a mathematical exercise which may have little relation to their actual operational risk capital and will divert them from seriously addressing operational risk management. As such, depending on the result of the mathematical exercise, it could also lead to firms, gaming the system and dis-incentivising them to pursue the AMA with its attendant much higher quality of operational risk management. The simpler approaches were always designed to be simple (rather than risk sensitive) in recognition of the difficulty of quantifying operational risk. By apparently attempting to introduce risk sensitivity to the simpler approach, the Committee has introduced additional complexity and potentially significant costs of implementation, without achieving any benefits since the risk sensitivity of the new approach has little validity.

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

A single standardised approach may be simple, but it is unlikely to enable serious comparisons between firms and, especially, their sensitivity to and appetite for operational risk.

We welcome the amalgamation of business lines in the interests of greater simplicity, albeit we believe there is evidence (for instance in the ORX database) to suggest a statistically significant difference in the operational risk profile of different business lines (e.g. according to the ORX data, retail banking and trading and sales business lines experience more than double the gross loss in proportion to gross income compared to corporate finance and clearing business lines between the period 2008-2013). In any case, much operational risk can reasonably be attributed to decisions made outside income producing business lines. The revised approach perpetuates this latter weakness in the methodology and so adds little whilst introducing additional complexity and cost.

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

Under the current simpler approaches GI is taken as an average of the last 3 years. Is this to apply to the BI? The only reference we can find to the BI and 3 years is in paragraph 40, under the section concerned with banks which have very high or very low interest margins. If the Committee intends the BI to be based on a 3 years' average, we wonder whether it might be preferable to select the highest interest and financial components over that period and so reduce pro-cyclicality. In addition, in relation to the fee element, there is an argument for replacing the 3 year average with a cumulative value of fees over a 7 year period. Indeed, given the lagging nature of certain operational risk events, a 7 year time-frame generally might be more representative and less pro-cyclical than the current proposals.

At the end of paragraph 26, there is a reference to Annex 2. As with the majority of potential respondents to the paper, and perhaps also members of the Committee, we are not competent to comment on the Annex. The content of the Annex simply underlines our point about the spurious accuracy of the Committee's proposals and the impenetrability of its logic.

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

We are concerned that there will be limited data to support the calibration of the lower buckets. It may be helpful to see whether the loss distributions fitted to the higher buckets would generate similar levels of loss in the lower buckets.

We also wonder, especially in the lower buckets, whether there is a survivorship bias in these buckets. To what extent have failures of firms or their merger with other or larger firms been taken into account?

Whilst we can understand the Committee's reasons for rejecting scenario analysis as a basis of assessing operational risk capital on a standardised basis, we strongly believe that scenario analysis is probably the best method available and we would urge the Committee to use it to test the appropriateness of the capital levels suggested. The Committee should also consider providing guidance to banks and supervisors on how to use scenario analysis as part of the pillar 2 assessment of operational risk.

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 do not have the benefit of the Committee's evidence, but it would be helpful in considering this question if data had been provided to understand how many banks might be expected to fall into each bucket.

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

Again, we do not have the data to understand, as the Committee presumably does, the extent to which the revised approach will change the quantum of operational risk capital, both for different sized firms, for the global quantum of operational risk capital and, therefore, the total global quantum of minimum regulatory capital.

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

The compliance costs of moving from the current simpler approaches to the new approach will be non-trivial for internationally active banks, even more so given local regulators will undoubtedly implement national variations that will need to be assessed and complied with. If the EU adopts the new approach (as we assume it will) the compliance costs and implementation challenges of applying the new approach across some 15,000 banks and investment firms will be very significant, and will consume significant resource of both banks and supervisors.

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 consider that it is not appropriate to adjust the standard formula for highly specialised fee businesses. Operational risk is often their biggest risk and it would be strange if an adjustment led to lower regulatory capital for these businesses than they warranted, although we have no data to test this assumption. As with other firms, if they felt that they were being unduly penalised, they have the option of pursuing the AMA.

See also our comments on term in our response to Q3.

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

The fundamental solution, as the Committee identifies at paragraph 47, is for banks to operate sound management of operational risk. That means all banks and requires excellence and understanding by supervisors in driving up standards. Unfortunately, despite the heading to the last section, there is continuous reference in paragraphs 47 - 50 to 'large internationally active banks'. This is a small, admittedly important, sub-set of the global population and it is disappointing that the Committee, in concentrating on a revision of the mathematical methodology, has not spent more time considering how to promote good practice amongst all banks.

The criteria outlined in Annex 4 do not appear particularly stretching, especially for large banks where we would have expected them to be part of normal risk management. More worrying is the failure to mention scenario analysis which, in our view, provides the best method for firms to estimate their forward-looking capital requirements. We would urge the Committee to promote scenario analysis and include detail on how effectively to perform such analysis. We would be pleased to assist the Committee in this.

Yours sincerely,

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