POSITION PAPER

WSBI-ESBG common response to the Basel Committee consultation on the revision of simpler approaches of the Operational risk framework

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WSBI ESBG

WSBI-ESBG would like to thank you for the opportunity to comment on the Basel Committee consultation on the revision of simpler approaches. *Generally speaking, we welcome the revisions proposed in this consultative document.* However, we consider that some aspects should be clarified or reconsidered in order to reach the objectives aimed. Below you will find specific comments regarding these matters.

1. SPECIFIC COMMENTS

1.1 Refinement of the proxy indicator of operational risk exposure (paragraph 12)

In relation to the investigation of the proxy indicator of operational risk, the Committee considers that financial statements-based proxies for operational risk based on assets and liabilities are affected, among other things, by valuation and accounting practices, and fail to capture operational risk associated with off-balance sheet or fee-based business. Therefore, the Committee's analysis focused on the financial statements-based proxies for operational risk based on income and expenditure to identify the Business Indicator (BI).

However, we should point out that financial statements-based proxies for operational risk based on income and expenditure are also affected by valuation and accounting practices. As an example, formalisation fees linked to a credit may be affected by different accounting practices across jurisdictions. Moreover, the BI approach may also skip some elements (e.g. IFRS periodification of fees based on the lifetime of the products). Therefore, as well as the previous example, those fees, which are one-time fees in long-term products, may be omitted due to the different accounting practices.

Several components of the BI lack an intuitive connection with operational risk exposure. For instance it is very difficult to see why a reduction in interest expense would increase the operational risk exposure. Likewise, it is difficult to understand why it is beneficial to have a net interest income equal to zero. Well-organised banks with high credibility that are able to have low interest expenses are punished with the BI method when it instead should be the other way around. The current BI is thus inconsistent from a risk perspective, e.g. it punishes banks making profitable business through the interest component although profitability is the best protection against future losses.

We also disagree with the inclusion of Net P&L Banking Book in the BI due to operational risk in the generation of this kind of results is very low, being limited to errors in the transaction. In general the BI should be calculated with net values instead of the sum of components in absolute terms;

One argument put forward in favour of the BI over the current approaches is that banks experienced a decline in their gross income (GI) due to systemic or bank-specific events, including those involving operational risk losses, resulting in a decline in operational risk capital when intuitively this should have either stayed the same or increased. Unfortunately, no such comparison has been carried through. We agree that a proxy for operational risk should not decrease due to systemic or bank specific events. However, we do not see that the suggested replacement of GI solves this issue.

Furthermore, the relationship between fees and expenses should be carefully evaluated when added together to avoid double counting. Especially the leasing asset class would be severely punished by including leasing income and leasing expenses in other operating income and other operating expenses. The current GI under the simpler approaches is calculated net of leasing depreciation. We propose this rule should also apply to the BI in the revised approach.

1.2 Improving calibration of the regulatory coefficients

We agree that the exposure to operational risk does not increase linearly in proportion to the size of a financial institution. Introducing progressive regulatory coefficients could be a way to account for the non-linearity. However, the proposed buckets and coefficients lacks empirical support and using *"a kind of adjusted R-squared"* measure to identify relevant buckets sounds counterintuitive given that it is also stated that *"… it is well known that R-squared is an inadequate and inappropriate measure for non-linear regression".*

Additionally, the homogeneity assumption made in the OpCaR model is questionable, as there is evidence that losses in different business lines and event types have heterogeneous loss profiles. Hence, discarding the business line categorisation in the standardised approach will be a step backwards in the attempt to capture the complexity of a financial institution.

Calculating OpCaR based on the average of six different distributional fits may not be the most appropriate method for estimating the annual loss at 99.9% confidence level for individual banks. From sensitivity analysis it is clear that in many cases the OpCaR model averages over a very wide range of capital estimates, dominated by outliers.

1.3 Risk management expectations under the revised SA

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

It is important to strengthen the link between risk measurement and risk management. We deem that the revised approach is oversimplistic and just replacing a size indicator (GI) with another (BI) does not encourage the industry to improve its operational risk management. Banks taking steps to diversify its business and reduce complexity should according to our mind be encouraged to do so. In our view the most effective approach to promoting rigorous operations risk management should necessarily include incentives as haircuts in capital consumption.

Moreover, we consider that more clarity is needed with regards to what is stated in Annex 4.Annex 4: *Loss data collection and risk management guidance for large internationally active banks under the revised SA for operational risk*, foresees that the bank should identify and gather information regarding, among other things, opportunity costs/loss revenues that may provide useful operational risk management information. We understand that further explanation is necessary, in particular in the way for calculating them, in order to avoid, among others, overlapping other risks (e.g. legal risks). Otherwise, we strongly believe that no reference should be made to this point.

Furthermore, in the Annex the bank's risk management framework is requested to include mapping and reporting of gross income and loss experience by business line or activity. However, the revised Standardised Approach (SA) is based on a single indicator of operational risk exposure with size-based coefficients instead of the business line-based beta factors, as set in paragraph 8 "… it was therefore considerate appropriate to develop only one approach based on a single indicator of operational risk exposure with size-based coefficients instead of the business line". Therefore, we understand that the detailed information requested is not relevant for the revised SA. If this is not the case, the Committee should clarify the information in relation to those "business line" and further explanation regarding the information referred would be welcomed.

1.4 Definition of Business Indicator (Annex I)

Annex I sets out which components should be included in the business indicator (page 17) and which components should not contribute to it (page 19). For the BI three macro-components are considered: interest, services and financial. We believe that net gains/losses on financial operations for the trading book should be included in the financial component. One of the sub-items should be 'realised net gains/losses on financial assets and liabilities not measured at fair value through profit and loss (available for sale financial assets, loans and advances, held to maturity investments, financial liabilities measured at amortised cost)'. In the profit and loss statement of FINREP this position is presented on the face of the p&l.

However, page 19 of the Consultation lists sub-items which should be excluded from this exercise. One of the listed items is 'net gains/losses on derecognition of financial assets, liabilities not measured at fair value through profit or loss'. As a matter of fact, a derecognition results in realised gains or losses in the profit and loss statement. Therefore the aforementioned positions comprise the exact same content and therefore cause a contradiction.

Therefore, we would find it very helpful if the treatment of "realized gains/losses on financial assets and liabilities not measured at fair value through profit and loss" were clarified in order to be able to establish a BIA-value according to the BCBS Consultation.

1.5 Implementation

Finally, we would welcome information in relation to the date stipulated for the implementation of these changes or the implementation schedule. This is especially important due to the large impact on capital requirements under the revised approach.

About WSBI (World Savings and Retail Banking Institute)

WSBI brings together savings and retail banks from 90 countries, representing the interests of approximately 7,000 banks in all continents. As a global organisation, WSBI focuses on issues of global importance affecting the banking industry. It supports the aims of the G20 in achieving sustainable, inclusive and balanced growth and job creation around the world, whether in industrialised or less developed countries. WSBI favours an inclusive form of globalisation that is just and fair, supporting international efforts to advance financial access and financial usage for everyone. It supports a diversified range of financial services that responsibly meet customers' transaction, saving and borrowing needs. To these ends, WSBI recognises that there are always lessons to be learned from savings and retail banks from different environments and economic circumstances. It therefore fosters the exchange of experience and best practices among its members and supports their advancement as sound, well-governed and inclusive financial institutions.

WSBI represents more than 6,150 financial institutions from 82 countries. At the end of 2011, these institutions operate through more than 227,000 branches and outlets, employ more than 2.2 million people and serve more than 600 million customers. Assets of member institutions amounted to more than US $15.6 trillion at the end of 2011.

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About ESBG (European Savings and Retail Banking Group)

ESBG brings together savings and retail banks of the European Union and European Economic Area that believe in a common identity for European policies. ESBG members support the development of a single market for Europe that adheres to the principle of subsidiarity, whereby the European Union only acts when individual Member States cannot sufficiently do so. They believe that pluralism and diversity in the European banking sector safeguard the market against shocks that arise from time to time, whether caused by internal or external forces. Members seek to defend the European social and economic model that combines economic growth with high living standards and good working conditions. To these ends, ESBG members come together to agree on and promote common positions on relevant matters of a regulatory or supervisory nature.

ESBG members represent one of the largest European retail banking networks, comprising of approximately one-third of the retail banking market in Europe, with total assets of over €7,300 billion, non-bank deposits of €3,480 billion and non-bank loans of €3,950 billion (31 December 2012).

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