

POSITION PAPER

WSBI-ESBG response to the BCBS consultation on the Standardised Measurement Approach for operational risk

WSBI (World Savings and Retail Banking Group)

ESBG (European Savings and Retail Banking Group)

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WSBI



ESBG



Dear Sir/Madam,

Thank you for the opportunity to comment on the BCBS consultation on the *Standardised Measurement Approach for operational risk*. We would like to share with you the following reflections that we hope will be appropriately taken into account by the BCBS:

General comments

First of all, we would like to pick up the often heard quote “no substantial increase in capital requirements”. According to our information, the QIS appears to show substantial increases: in general, 75% of banks face increases in capital charges. The median change is a capital increase of 33%, the mean change an increase of 61% and a quarter of banks face an increase of more than 70%. In particular, some jurisdictions, Europe being the most penalised one, could suffer an increase of 63% in comparison with the current regulatory requirements¹. The BCBS proposal seems far from having a neutral impact on capital and one could even question whether the proposal respects the “level playing field” principle.

WSBI-ESBG has found several inconsistencies and gaps in the BCBS’s proposal that we would like to address below. That being said and regardless of the fact that it seems the Committee has already discarded alternatives which are different to the SMA, we would like to emphasise that we regret the withdrawal of the Advanced Measurement Approach (AMA). Whilst we understand the argument of great variability of RWAs, the withdrawal would come at a time where new research findings on the modelling of operational risk appear on a regular basis. There would thus be a true opportunity to somewhat narrow down practices, perhaps assisted by supervisory guidance, just at the time where the approach is withdrawn.

Speaking about one of WSBI-ESBG’s members, a number of entities have been applying the AMA for calculating the own fund requirement for operational risk under Pillar I since 2009. The current approach is based on internal modelling and includes internal and external loss data, scenario analyses and business environment and internal control factors. Hence it covers all applied techniques and methods of operational risk management.

More generally, changing the own fund requirement calculation towards a formula-based approach, mostly dependent on business indicators, could be a somewhat decreased driver for proper operational risk management, in our view.

Another WSBI-ESBG member reports that their experience with AMA-type models used for ICAAP purposes in small financial institutions provides clear evidence that it is just the reduction in the risk profile of one or two established risk measures which triggers a reaction by the financial institutions, firstly of the data, secondly of the underlying processes, and thirdly of operational risk itself. It will be impossible to disseminate such models when supervisors clearly signal to the banks that they don’t trust them, by withdrawing the AMA.

To mitigate the withdrawal of the AMA, the BCBS could consider an alternative approach that combines the opportunity of using internal models and the SMA, such as the following:

¹ See [ORX: Capital Impact of the SMA](#) - ORX benchmark of the proposed Standardised Measurement Approach, 2016.



$$\text{Operational Risk Capital} = \alpha \times \text{Internal Model} + (1 - \alpha) \times \text{Standard Model},$$

where α is a factor between 0 and 1 agreed by each bank with its supervisor.

Where a bank has a poor model, or insufficient data, alpha is set at 0 and so the standard rules apply. As supervisors become more comfortable with a bank's internal model, alpha approaches 1 and greater benefit can be obtained from good modelling. Nevertheless, if the factor was set within the range of 0 and 1 the supervisor should base its decision on a clear list of conditions, predetermined by the regulator, and it should be accompanied by a sound justification.

What is more, it is not entirely clear to us how the BCBS's proposed methodologies impact Pillar 2 models. As the Pillar 2 models should capture the risks that the Pillar 1 models do not capture, the changes to the Pillar 1 calculation might potentially make calculation of additional Pillar 2 charge unnecessary, as the new increased Pillar 1 requirement might be bigger than old Pillar 1 + Pillar 2 requirements. This is the reason why we would appreciate some more clarifications from the BCBS in this respect.

Coming back on the SMA, and before answering specific questions of the consultation, WSBI-ESBG would like to point out a few inconsistencies, the sometimes existing lack of transparency and gaps that we have identified, and which should be addressed by the BCBS:

1. We are surprised that the quality of the risk management has no impact on the final capital requirement. This BCBS consultation doesn't offer any positive reinforcement towards more robust procedures, policies and manuals, which are determinants in an appropriate management of operational risk
2. We would appreciate to get more information about (i) the results and reasons why certain components were used for both the business indicator and the loss component and (ii) the data used and the methodology to obtain calibrations of the SMA. This would increase the transparency and the understanding of the suggested approach. It would also be helpful for the pillar 2 assessments in the ICAAP as the banks would be able to compare the bank's own risk and capital assessments directly with the foundations for the pillar 1 capital requirement.
3. According to the aforementioned ORX analysis (see footnote 1), larger banks would hold proportionally more capital under SMA than smaller ones, indicating the calibration is skewed ("Taken together, bank size appears the biggest determinant of capital levels under the SMA. Larger banks hold proportionally more SMA capital, have the biggest increase beyond current regulatory approved capital, and experience the largest impact from the loss component").
4. We, too, understand the approach that a group, where most of its entities are currently applying AMA, would fall into bucket 1 of the BI component. On the other side, the group seen from the consolidated level would probably reach bucket 3 of the BI component. Consequently, on a local level the loss data collection would not be necessary for a number of entities. What would be the suggested scenario for this constellation?
5. Additionally, with regard to the issue of allocated capital charges per entity (based on consolidated calculation), WSBI-ESBG has been wondering if it should be comparable to stand-alone calculations, and if there are any stand-alone calculations expected.



6. Furthermore, there exists another issue related to groups, in our view: on a consolidated level, groups can, as described above, end up in bucket 2-5, even if all companies within the group at a solo level will be in bucket 1. That would add a “super-additivity” to a group’s consolidated own funds requirements. The effect is that the group will need to hold capital that is not needed in any single company within the group. Issues regarding the allocation of such capital/own funds requirements will then arise – and not at least an issue regarding how to employ that capital in order to create the necessary return on the capital.
7. The consultative document does not mention deductions in capital requirements related to provisions yet accounted in P&L. As far as capital requirements are set to cover unexpected losses, provisions already accounted for should be deducted from the capital consumption, in our view.
8. The loss component structured by thresholds increases instability by introducing significant increments in the loss component for marginal increases in losses (i.e. a EUR 1 loss increase could increase the loss component by 10%). To avoid this type of jump, a progressive approach should be considered.
9. In the current standard the differences of risk profiles in function of the business lines are captured, while the SMA ignores this and applies the same treatment for all business lines. WSBI-ESBG has difficulties agreeing with this approach as clear differences in risk profiles have been observed in the past.
10. Finally, we believe that the BCBS could provide guidance in respect of the treatment of divested business lines.

Question 1: What are respondents’ views on the revised structure and definition of the BI?

WSBI-ESBG has doubts that the structure would actually ensure the goal of comparability, particularly in the case of those elements which are dependent on regional accounting standards. We believe that more guidance is required in order to achieve the objective mentioned above.

From a reporting perspective it is unfortunate that lease components, both finance and operating, are treated in the way proposed in the BI calculation.

The exclusion of net interest income requires detailed reporting efforts for being able to do so. Since FINREP reporting was recently introduced (in 2014) and IFRS reporting is aligned regarding P&L reporting, changes to that would lead to amended reporting structures and therefore to additional efforts and (unnecessary) costs. It should be considered that, depending on the particular legislative implementation, current FINREP reporting for finance lease might not always include a reporting requirement regarding an interest income component. Without this position, it is not possible to calculate the BI according to the way it is presented in the consultation paper. WSBI-ESBG would also like to highlight that the effect of extracting the lease component from net interest income would give only minor results that usually do not affect the overall picture of an institution.

Therefore, in WSBI-ESBG’s view, a new BI calculation with sophisticated formulas should at least take into consideration current FINREP reporting availabilities on one side, and potential new burdens of a separate reporting requirement with at least doubtful effects on the other side.



Furthermore, an aspect that we do not fully grasp is the following: currently, there are three methods to calculate operational capital requirements, and each method has different qualitative requirements. If the BCBS heads towards more harmonisation or even withdrawal, are the qualitative requirements going to be harmonised? The consultative document only harmonises loss collection, in our understanding but it lacks clarity on the loss definition. As mentioned above, we believe that comparability is not guaranteed without additional guidance in several issues, for example on how to treat recoveries. On the other hand, the inclusion of balance sheet items (assets) in the BI definition could reduce the coherence of the BI as a proxy indicator for operational loss exposure.

Moreover, we consider, according to Art. 316(b) Capital Requirements Regulation (CRR), institutions should not use the following elements in the calculation of the relevant indicator: realised profits/losses from the sale of non-trading book items; income from extraordinary or irregular items; income derived from insurance. In terms of coherence, WSBI-ESBG additionally proposes to exclude expenses required to obtain income from investment properties.

Question 2: What are respondents' views on the inclusion of loss data into the SMA? Are there any modifications that the Committee should consider that would improve the methodology?

We acknowledge the inclusion of loss data into the SMA, compared with the method proposed in the consultation on "Operational risk - Revision of the simpler approaches" issued in October 2014. Nevertheless, we would like to refer to some topics and concerns [a) – h)] in order to increase the reflection of risk profile and risk management within the SMA.

Another point worth mentioning is that currently, a loss of over EUR 100 million is recognised through the formula 19 times (7+7+5) as the wording doesn't state if these intervals are discrete or not. This exacerbates the impact of this loss out of proportion. Thus, this should be clarified, according to our opinion. Additionally, a loss data for the last 10 years seems to be very excessive and in case of extraordinary events in line with this massive multiplication as shown above, it creates a misinterpreted requirement that carries on for these 10 years. Operational risk changes fast (e.g. due to technological changes, digitalisation), which leads us even more to the conclusion that requiring loss data for the last 10 years seems to overshoot the mark.

It is unclear if the calculation approach should be "bottom-up", i.e. losses and BI on the most granular level aggregated up to a consolidated figure, or "top-down", i.e. a consolidated figure calculated and distributed down to all subsidiaries. What would be the key to allocate? Both approaches have their downsides. The former skews as some of the entities (ancillary services companies) have no or hardly any losses and the latter skews in a way that non-credit institution losses are a part of the credit institution losses. Ancillary services subsidiaries are using a Basic Indicator Approach, so their IT systems need to be geared up to be able to start capturing internal losses data. Therefore, an exception for those subsidiaries should be considered.

As indicated above, some qualitative aspects seem to be missing in the SMA. Particularly for the loss data, event type classification is not considered in the SMA, which opens the question of the benefit obtained from investing in the collection of data on event types, which is a regulatory requirement.

Apart from this, we welcome the introduction of a loss multiplier into the SMA, especially in case the AMA would be withdrawn. We cannot agree, however, with its introduction exclusively in buckets 2-5. We feel that this is discriminatory against bucket 1 institutions. We would therefore like to suggest to the BCBS to develop an approach which allows bucket 1 institutions to enjoy the same options as



institutions in buckets 2-5. This is all the more urgent as the incentive towards a better operational risk management would be most welcome for bucket 1 institutions.

Currently, banks have different loss thresholds. It could therefore be considered to harmonise them to avoid distorting capital requirements.

a) Recognition of insurances and other risk transfer mechanisms

Currently, applying an internal model within AMA provides the possibility to account for the risk mitigating effect of insurances and other risk transfer mechanisms in order to reduce the own fund requirement for operational risk. We believe that having an insurance framework in place gives a better understanding of operational risk potential throughout an entire group. It clears the focus regarding problematic aspects as well as opens opportunities for diminishing costs or even structural/organisational problems and therefore gives a positive incentive for business. The P&L relief and lowering the own fund requirement both represent an additional incentive for risk management.

Hence, we propose to reconsider and include the risk mitigating effect of insurances as part of the loss component as well. Moreover, this would also be in line with the general approach of measuring credit risk where insurances are part of risk mitigation factors.

We would also appreciate a simple and transparent way to capture the insurance aspect in the SMA by including gross loss amount net after insurance recovery in the loss component. WSBI-ESBG strongly believes that this would incentivise banks to transfer operational risks by underwriting insurance policies.

b) Considering the aging of loss data

Within the AMA, at least five years of internal data have to be considered for calculating the own fund requirement for operational risk. This time frame seems to be reasonable in order to capture enough loss events with the calculation and it also avoids an overestimation of the appropriateness of “older” (date of discovery more than five years ago) loss events. Generally, processes and products change over time and “older” loss events provide less information about the current risk profile and risk management situation of the Group.

Therefore, WSBI-ESBG would like to propose to limit the consideration of loss data to a five-year time horizon which is comparable to current standards. Alternatively, we propose to give older loss data (date of discovery more than five years ago) a proportional risk weight which can also be gradually (e.g. percentile) adjusted.

c) Qualitative methods

As already mentioned above, it is seen as an improvement to incorporate loss data within the calculation of the new SMA. Unfortunately, other qualitative methods like risk control and self-assessments (RCSA), key risk indicators (KRI) or scenario analyses are not taken into consideration for calculating the own fund requirement. But these methods represent important tools for an adequate operational risk management and the incorporation of operational risk within business lines. Having proper techniques in place does improve the overall risk management, and therefore it should be reflected as an input factor in the own fund requirement. We would be concerned if these methods were taken out of the operational risk management at the end of the day, which would also mean cutting back its importance within the overall risk management process.



Thus, WSBI-ESBG proposes to extend the SMA with a component reflecting scenarios and business environment and internal control factors as well. This would also add more forward-looking approaches to the calculation of own fund requirements. Quality standards, for instance, could be contemplated as well in order to prevent arbitrage or the distortion of the level playing field.

d) Outcome of the SMA

As far as we understood the concept of the SMA, the main goal was to derive a certain comparability and stability of own fund requirements for different banks. However, especially the requirement for stability cannot be ensured by the current SMA proposal, in our opinion. Large loss events (above EUR 100 million) would be considered three times in the loss component, which creates a significant over-estimation of their impacts and could lead to instability of the SMA when the reflecting numbers of loss events enter the considered timeframe, as well as when it drops off.

Additionally, events close to the threshold for large events can cause instability. For instance, a loss of EUR 99 million could lead to a significant increase in the loss component when it slightly increases to EUR 101 million, e.g. in the next quarter. Although the loss is almost the same size, the effect is quite different without any substantial reasoning. A possible way to lower instability regarding large losses which have had impact over several years, and considering capital is calculated for a year horizon, would be to consider splitting these losses also into yearly segments for the capital requirements.

e) Minimum floor for losses

WSBI-ESBG would like to ask for defining EUR 10.000 as the minimum floor for losses included in the loss component for all entities, irrespective of internal floors in each entity.

f) Definition of data regarding the calculation of loss components

Currently, the explanation on which kind of losses should be used for calculation of the loss component is providing a general idea of the required loss data. But additional clarification would be necessary in order to ensure that all banks are using the same kind of data.

How should banks account for the fact that (most of the) entities within a company might have a data base reflecting ten years of history but other mostly smaller entities/subsidiaries might work with shorter timeframes? Are there any temporary arrangements under consideration?

g) Restructured banks

In certain Member States, due to the recent financial crisis, some banks were restructured to fix severe imbalances built up in previous years and have been subjected to bail-in procedures that have had a significant impact on the treatment of former shareholders and owners of hybrid instruments, such as preferred shares or subordinated and senior debt. The detriment suffered was successfully sued in court, forcing banks to compensate the losses and resulting in several big events of operational risk totally unrelated to the current business model implemented by the institutions.

A disproportionate losses multiplier is generated by these massive events, when the loss component, that collects these singular losses, outweighs the business component, coming from the usual business model.



Therefore, ESBG suggests not using the losses arising from these events, or to place a maximum limit on the losses multiplier to cope with this misalignment between both components, so that the impact of these unique events could be smoothed, avoiding penalising the calculation of requirements during 10 years.

h) Transitional period

Banks have merged and new banks may not have reliable information on the losses from the previous institutions they incorporated. Due to this it would be desirable to include a transitional period adapted to the number of years of sound information. The loss multiplier could be calibrated as follows, with a minimum period of five years:

- Average loss multiplier. 3 as starting point and a yearly increase of 1 point, ending at 7.
- Loss multiplier for losses larger than 10 million. 3 as starting point and a yearly increase of 1 point, ending at 7.
- Loss multiplier for losses larger than 100 million. 2 as starting point and a yearly increase 1 point, ending at 5.

Question 3: What are respondents' views on this example of an alternative method to enhance the stability of the SMA methodology? Are there other alternatives that the Committee should consider?

In our view, the description of the alternative method is very unspecific, which is why we are not able to give a clear and final statement. We have asked ourselves, for instance, how factor m in the formula should be determined? Is it considered that m is a stable value or should m be adjusted on a regular basis?

Taking the unclear definitions into consideration a first analysis has shown that the described alternative method seems to lead to more volatile results. We would therefore appreciate to have a more detailed basis for any further analysis as well as further suggestions.



About WSBI (World Savings and Retail Banking Institute)

WSBI brings together savings and retail banks in all continents and represents the interest of circa 6,000 financial institutions with total assets of USD 14 trillion and serving some 1 billion customers in 80 countries worldwide (2013 figures). As a global institution, WSBI focuses on international regulatory issues that affect the savings and retail 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 globalization 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 meet customers' transaction, savings and borrowing needs responsibly. To these ends, WSBI recognizes 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.



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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 €6,702 billion, non-bank deposits of €3,485 billion and non-bank loans of €3,719 billion (31 December 2014).



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