December 31, 2014

Mitsutoshi Adachi
Chair, Working Group on Operational Risk (WGOR)
Basel Committee on Banking Supervision (BCBS)
Centralbahnplatz 2
Basel, Switzerland

**Re: Operational risk – Revisions to the simpler approaches**

Dear Mr. Adachi:

The Institute of International Finance (IIF), the Global Financial Markets Association (GFMA), the International Swaps and Derivatives Association (ISDA), and The Clearing House Association L.L.C. (TCH; and together, the Associations) appreciate the opportunity to comment on the Basel Committee on Banking Supervision's (BCBS) proposed revisions to the simpler approaches for operational risk. The Associations also commend the open dialogue with the industry that the Basel Working Group on Operational Risk (WGOR) fostered for a number of years now, including the recent meeting with representatives from the industry on December 10, 2014. We consider this open dialogue to be very valuable not only in allowing us to express industry views but also to allow the industry to have a better understanding of the work (and its rationale) that the Basel WGOR is undertaking.

The Associations strongly support the Basel WGOR's objectives to address issues and weaknesses in the current simple approaches for operational risk, as the industry shares the same goal of having a more robust operational risk regulatory capital framework.

However, we believe there is still room to enhance the risk sensitivity of the proposed new framework relative to the existing one, which is a stated objective of the proposed revisions. In particular, we support certain changes to the treatment of the different business areas/models. For example, the treatment of businesses that would fall under the Services component of the Business Indicator (BI) seems unwarranted. We explain this in more detail in our specific comments below.

The proposed revisions also put a lot of emphasis on firm size, with the operational risk capital requirement changing effectively only with firm size and not taking into account the quality of a firm's operational risk management, which we believe is an important element in a robust operational risk capital framework. This appears counter to the goal of enhancing risk sensitivity for the new framework.

We understand that the revisions pertain only to the simpler approaches of operational risk and thus the level of risk sensitivity has to be balanced with simplicity and comparability. However, we believe the BCBS should take this valuable opportunity to ensure that the new framework truly exhibits enhanced risk sensitivity relative to the existing framework because of the following two reasons.

First, the BCBS has recently issued a consultation on capital floors on the internal models approaches based on standardized approaches[1]. If such floors were introduced, it would underscore the need for enhanced risk sensitivity in the new standardized approaches. As mentioned in the BCBS report on *Reducing excessive variability in banks' regulatory capital ratios* (November 2014), "…greater risk sensitivity embedded in the revised (standardized) approaches will improve their use as a basis for the implementation of a capital floor, while continuing to provide a fallback option…".

Second, there is a lot of emphasis on additional disclosures and we understand that Pillar 3 requirements for operational risk will be forthcoming. One of the goals of Pillar 3 is to disclose banks' capital requirements (and the corresponding elements) to make banks' risk profile more transparent to the market. This goal would be enhanced with a more risk sensitive capital framework.

Therefore, the concern is that by having less risk sensitivity relative to the existing framework, the new framework may not be able to achieve the enhanced role that the BCBS envisages for standardized approaches.

Because of these reasons, we were confused by the Basel WGOR statement at the December 10 meeting that the goal is to have sufficient capital at the industry level and not necessarily at the individual bank level. We believe the regulatory capital requirement is meant to make the individual bank more resilient to shocks as regulatory capital is a micro-prudential tool. If the regulatory capital framework is focused solely on adequate capitalization for the industry as a whole, it may lead to a scenario where a bank under severe operational stress turns out to be undercapitalized.

We understand that the BCBS's goal is to strike a balance between simplicity, risk sensitivity and comparability, and not just to pursue simplicity. A regulatory capital framework that considers only the level of capital at the industry as a whole will not be able to differentiate riskiness among different banks. At best, it would only work well on an "average" bank (if there is any that would fall under this category). In addition, the comparability goal may not be appropriately enhanced by such a framework. The concept of comparability means that banks with similar risk

[1] This comment letter does not include the Associations' views on the use or applicability of capital floors. The issue of capital floors will be addressed in our response to the BCBS Consultative Document on *Capital floors: the design of a framework based on standardized approaches*, which was issued on December 22, 2014.

profiles should have similar capital requirement. This goal will not be achieved with a framework that does not properly reflect risk at the individual bank level, since banks with similar risk profiles may end up with different capital requirements.

One of the underlying concerns of the Basel WGOR seems to be the application of the new framework to smaller banks that may not be able to comply with a more complex approach (i.e. banks that are under the Basic Indicator Approach or BIA). However, the BCBS has always maintained that the Basel regulatory capital framework is intended for internationally active banks. These banks should be expected to be able to comply with at least a slightly more complex approach than the BIA. There could be ramifications on international financial stability if such banks are held to standards that favor simplicity over risk sensitivity. While we support having a very simple approach for non-internationally active banks (perhaps consider retaining the BIA, if necessary), this should not hold back the BCBS from truly achieving the goal of striking the right balance between simplicity, risk sensitivity and comparability in the regulatory capital framework for internationally active banks[2].

Below, we offer more detailed comments on the proposed revisions that reinforce the points we raised above and in our meeting on December 10, 2014. In some areas we offer some suggestions that may lack the statistical proof that the Basel WGOR may wish to see. Given the limited time and limited access to data that the Associations have, these suggestions are intended more as ideas that the Basel WGOR may wish to consider as it continues to do its analytical work. Given the access to data that the Basel WGOR has, hopefully these would not be challenging propositions. As always, we offer our support to the Basel WGOR in conducting any necessary studies.

## General comments

### *Revisit the foundation of the proposed new framework*

As indicated by the Operational Risk Exchange (ORX)/IIF benchmark study presented to the Basel WGOR on December 10, the proposed new framework will have a significant capital impact on banks. Thus, it highlights the need to ensure that the new framework has robust and sound quantitative basis.

The proposed new framework is based on the Operational risk Capital-at-Risk (OpCaR) methodology developed by the BCBS. The OpCar methodology is a simple modelling approach, which does not employ some of the key modelling

[2] The BCBS consultation document on the *Revisions to the Standardized Approach for credit risk*, for example, is considering maintaining the simplified standardized approach for credit risk. It states that the “Committee wants to ensure that a simple methodology remains available for a wide range of jurisdictions and non-internationally active banks where the cost of compliance with more complex standards may not be warranted” (Section 1.1, page 3). This should also be considered in the case of operational risk.

standards required or expected of banks' AMA models or industry practice. An example of this is the OpCaR model assumption that all operational risk losses across banks are sufficiently homogenous to model them within a single unit of measure. Consequently, there is concern that the OpCaR model may not be sufficiently robust to reliably calibrate the required level of capital for standardized approach banks. For example, based on the same ORX/IIF study, the OpCaR methodology appears to result in widely diverse numbers depending on the distributions used. Basing the capital requirement on the "average" of these widely diverse numbers raises some concern about the appropriateness of the resulting capital charge.

Moreover, there are still unanswered questions regarding the sensitivity of OpCaR output when applied to various data across time, loss thresholds, and bank sizes. We understand the Basel WGOR intends to analyze additional data collected and we strongly support an effort to study these issues further and strengthen the calibration approach accordingly. An aim of the proposed new approach is simplicity and while this is appropriate for the standardized approach calculation undertaken by banks, this should not imply that the method of regulatory calibration for the level of bank's capital, which is only undertaken every few years, should be less robust than that required of a sound operational risk modelling approach.

*Publication of summary of analyses undertaken*

We appreciate the Basel WGOR's consideration of our request to publish the summary of analyses that have been undertaken or that will be undertaken to provide greater transparency into the modelling choices and assumptions, and improve industry's understanding of key decisions and conclusions that have been made. We look forward to the publication of these analyses, and are particularly interested in the following areas:

- The conclusion that the original Basel II business lines did not differ significantly in terms of their operational risk profiles;
- The preliminary calibration of a [five]-bucket structure specifically the cluster analysis that was then carried out on the UL smoothing function with the aim of (i) aggregating in the same bucket banks showing a similar risk profile; and (ii) identifying the most appropriate number of buckets for the sample;
- The sensitivity analysis to support the use of a conditional expected loss measure for calibration compared to a conditional median loss measure;
- Calibration of the regulatory coefficients and the increasing values from [10%] to [30%]; and
- The conclusion that banks' operational risk capital levels under the current Basel framework were on average already undercalibrated in 2009, the year for which the data were collected under the Committee's 2010 QIS.

*Backward-looking calibration highlights the need for regular review*

As pointed out in the IIF WGOR TSA Qualitative Analysis Paper (TSA Paper) that was submitted to the Basel WGOR in June 2014, 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 the 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 consultation document if the proposed revised standardized approach would be subject to regular review (particularly of the coefficients). The Associations support such a review and believe that regular review is necessary to make sure the revised standardized approach remains reflective of banks' actual risk profiles. Additionally, we believe the data collection effort should be on a sufficiently large scale to ensure a complete and robust data set.

In developing the OpCaR model, which was used to choose and calibrate the BI, internal loss experience was the sole metric used for calibration. We are concerned that this approach tends to be backward-looking and appears to conflict with the statement in the executive summary of the consultation document that "changing operational risk profiles of banks may render a calibration based on past behavior of variables unfit for the future." Accordingly, we support an approach that is forward-looking in nature, of which past experience is one component. We understand the challenges of including scenarios as well as business environment and internal control factors (BEICFs) in a regulatory model such as the 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 in order to ensure it remains appropriately calibrated.

*Quality of banks' operational risk management should be taken into account*

The IIF WGOR TSA Paper also advocated for a framework that would have a clear link between a bank's quality of operational risk management and its operational risk capital requirement. This would embed the right incentives in the capital framework. However, this is not the case under the proposed new TSA where operational risk capital requirements will only change with changes in income statement numbers and not with changes in the quality of operational risk management. We believe this should be added to the list of principles that the BCBS have kept in view in formulating the revised standardized approach (Section II of the consultation document). We have some suggestions below on how this could be addressed.

## Specific comments

### *Business Indicator (BI)-specific comments*

*Suggestions on how to incorporate operational risk management quality*

While we understand that expenses related to risk management are not supposed to be captured in the BI (otherwise it would be penalizing banks' investments in good risk management, which is counterintuitive), we propose that these expenses be incorporated in the BI as a type of proxy for the quality of banks' risk management. For example, these expenses could be used to offset or as a haircut to BI. This would provide a direct and quantifiable link between the quality of operational risk management and operational risk regulatory capital, as we advocated above, thus embedding the right incentives into the capital framework. However, while this is conceptually appealing, we concede that such an offset/haircut needs to be defined precisely in order to avoid arbitrary and inconsistent treatment between banks. We urge the Basel Committee to look at this proposal more closely together with the industry.

Another option might be to base this BI offset or haircut on supervisors' assessment of the quality of a bank's risk management practices. As we understand, the BCBS is considering introducing Pillar 2 capital add-ons to banks that fall short of the operational risk management standards outlined in Annex 4. We respectfully request that the supervisory assessments on whether or not to impose capital add-ons be based on clear, transparent, objective and harmonized guidelines across jurisdictions, and should not be imposed on banks that are already meeting the standards. In response to the Basel WGOR's question at the December 10 meeting on how to incorporate the quality of operational risk management in the capital requirements, we also propose that this capital adjustment be symmetric, with possible BI haircuts for banks that exceed the required standards.

*Concerns about treatment of fee-based businesses*

The proposed new framework does not differentiate between business models and assumes that all businesses have the same level of inherent operational risk, except for businesses that would fall under the "Services" component of BI. Such fee-based businesses are implicitly assigned a higher weight than the other components given that income and expenses are summed up instead of netted. While this would be understandable if there was a determination that such businesses were indeed riskier than the others, it is not clear whether an appropriate assessment has been made to arrive at such a determination since decisions on whether to net or sum up income and expenses have been based on the stability of the measures over the cycle and the

practicality of what is reported in the financial statements[3] [4]. This has the effect therefore of inadvertently putting at a disadvantage businesses falling under the "Services" component.

As an example, some banking groups may have significant fee-based businesses, such as leasing, asset management and consumer credit companies. Income and expenses from these companies are recognized at the group level as "Other operating income" and "Other operating expenses". Accordingly, both income and expenses will be aggregated when calculating the "Services" component. However, the treatment of income and expenses from other businesses (i.e. income and expenses from lending and trading activities) is different because only the net amount will be counted as part of the "Interest" and "Financial" components of the BI. This means the BI amount can be significantly different between banking groups depending on the core businesses of their subsidiaries, with banking groups that have large leasing companies or consumer credit companies likely to be at a disadvantage. The consultation document recognizes this potential for a disproportionately high capital impact for banks that are highly specialized in fee businesses.

Another consequence of this treatment of fee-based businesses is the asymmetric impact on the "distribute only" and the "originate and distribute" business models. The former requires adding up its income and expenses, while the latter requires adding up the net interest margin only from the origination side of the business and the income from the distribution side. We believe this is an issue that should be addressed and we would be interested in continuing our discussion from the December 10 meeting on this potentially unintended consequence.

Thus, for the Services component, we support a potential cap similar to the one proposed for high net interest margin (NIM). Moreover, another idea worth considering is to include only the maximum of total fee income and total fee expenses and the maximum of total operating income and total operating expenses in calculating the Services component of the BI. This will avoid double counting of business transactions that produce income and expenses (including risk mitigation expenses).

While we understand the Basel WGOR's request for information on impact of the proposals on fee-based businesses, we respectfully believe that there remains

[3] See paragraphs 18-21 of the consultation document. For the Interest component: "The Committee explored the possibility of using the sum of interest income and interest expense…However, it was observed that changes in interest rate levels would render this measure highly cyclical…" For the Services component: "The sum of fee income and expenses within the services component exhibits stable behavior over time." For the Financial component: "…it would not make a difference if the calibration were based on the sum of absolute values of gains and losses or the absolute values of net P&L from the trading and banking book activities as both measures are generally unaffected by cyclical changes in the economy. However, since gains and losses in the trading and banking books are typically reported in financial statements on a net basis, it would be more practical to use net gains or losses…"

[4] Although paragraph 22 of the consultation document states that the BI "increases the weight of components associated with activities more closely related to operational risk (e.g.…commissions from services payments, fees received from securitization of loans and origination and negotiation of asset-backed securities…) – many of which were at the core of the financial crisis", unfortunately it also lumps all other fee-based businesses into this higher weight.

a fundamental issue that the uniform treatment of all fee-based businesses does not appear to be warranted. Even if such businesses are not currently significant, the proposed treatment may serve as an unintended regulatory barrier to entry in the future.

*Suggestion to maintain risk differentiation between business areas*

Paragraph 8 of the consultative document states that "during the course of the analytical work carried out over the past two years, it became apparent that the business lines did not differ significantly in terms of their operational risk profiles when measured by portions of a proxy indicator multiplied by an associated coefficient." Paragraph 30 notes that "a similar result was obtained by industry studies." However, ORX observations found clear evidence of differences between business lines. In addition, the results of the IIF WGOR data collection exercise (results of which were presented to the Basel WGOR in June 2014) gave indications that some business lines are riskier than others (though may not be in the same ranking of "riskiness" as implied by the existing TSA betas). The IIF WGOR data collection exercise also gave indications that diversification works across business lines (i.e. there were several exceedences at the business line level but only one at the bank level). Moreover, banks' own experiences in running different businesses also indicate that some business areas have inherently more or less operational risk than others. However, the BCBS proposals view all business lines (and business models) to have inherently the same operational risk and seem to indicate that the only way to reduce risk (and capital requirement) is to reduce the size of the institution. We strongly support the Basel WGOR revisiting the use of business lines as an additional optionality for banks as we believe there may be useful information that would be lost if the focus of the regulatory capital framework is just on size alone.

Another suggestion that the Basel WGOR may wish to explore further is to differentiate weightings for the three BI components. This could improve risk sensitivity (including being able to correct the unintended implicit higher weighting for the Services component) while having relatively little impact on the simplicity of the approach. We respectfully request that the Basel WGOR conduct further analysis to determine the appropriate weightings for the Interest, Services, and Financial components of BI, and adjust the formula accordingly. The Associations would be happy to work with the Basel WGOR on any such exercise.

*Concerns about inclusion of "strategic" transactions in BI*

The Associations are concerned about the inclusion in the BI of transactions involving banking book assets for which realized gains are recorded (e.g. sale of AFS fixed-income securities), as this may be part of a bank's strategy to respond to the prevailing interest rate environment (e.g. to stabilize bottom line in an extremely low environment or to replace with

higher earning assets in an increasing rate environment). An approach that penalizes such strategy may inadvertently distort banks' incentives to properly manage its financial condition. We therefore recommend that the Basel WGOR consider excluding these strategic transactions in the formulation of the BI.

*Clarification needed on specific items to be included/excluded in the BI*

To ensure a harmonized interpretation of what are included/excluded in the BI, we respectfully request clarification from the Basel WGOR on the appropriate treatment of the following items:

- Cash incentive compensation;
- Marketing expenses;
- Occupancy expenses;
- Deposit insurance premium;
- Outside legal and consulting fees;
- Taxes on interest income (in some countries, these may not be considered as part of interest expense);
- Interest income from financial leasing (please confirm if this should be included in the Interest component, which is the same treatment for interest income from trading book positions).

It would be helpful to banks subject to the framework if any such clarification could be included in the final version of the new framework and/or the FAQs for the next QIS.

*Suggestion to calibrate by jurisdiction*

The indicative increase in capital under the proposed revisions does not appear to be commensurate to the loss experience observed in all jurisdictions. As such, we believe the new framework could be made more risk sensitive by calibrating the coefficients/bucketing using loss data for each jurisdiction, and allowing national regulators the discretion whether to apply the global coefficients or the jurisdictional coefficients. This jurisdictional approach must be considered only for small banks with very limited international operations, as they are less exposed to operational risk events outside their jurisdictions. We believe this approach would not reduce the comparability across jurisdictions as the outcome would better reflect differing risk profiles. This would also eliminate implications of the EUR currency conversion on non-EUR banks' capital requirements, which is discussed below.

*Treatment of high NIM jurisdictions and high NIM businesses*

The Associations believe it is important to consider an alternative approach for countries and businesses with structurally high NIMs that may be caused by factors such as high credit risk, competition, taxation, etc. In cases where high NIM is caused by high credit risk, the introduction of high levels of operational risk capital to capture high NIM would result in a double-counting of capital requirements that are already reflected in credit risk capital charges. As such, we support the BCBS's plan to introduce a cap and floor on NIM that is flexible enough to ensure applicability across jurisdictions. This cap and floor should also be introduced only if there is supervisory judgment that such adjustment is necessary. An automatic cap/floor may unintentionally hide actual size of lending operations. As a starting point, we recommend that the BCBS look at the existing cap on NIM under the Alternative Standardized Approach (ASA), which appears to work well for banks currently using the approach.

*Other comments/clarifications*

*Application of the new framework*

For subsidiarized business models, the proposals would result in higher capital requirement when calculated directly at the consolidated level as opposed to summing up the capital requirements at the subsidiary level. We believe this result does not appropriately reflect diversification effects at the consolidated level. We therefore prefer the latter approach in calculating the consolidated capital requirement for operational risk.

For institutions that only partially use the standardized approach to calculate operational risk capital, there may be two likely scenarios. For a banking group that is predominantly AMA but with one or a few legal entities under the standardized approach, we believe the relevant coefficient/s in calculating the capital requirement for the legal entity/ies should be the coefficient/s applicable to the legal entity/ies under the standardized approach (i.e. not the group coefficient). For a banking group that is predominantly AMA but the standardized approach is used by a business unit/s within an AMA legal entity, we believe the relevant coefficient/s in calculating the capital requirement for the business unit/s should be the coefficient/s applicable to that particular business unit/s (i.e. not the group's nor the legal entity's).

*Comment on the risk management standards under Annex 4*

Annex 4 provides an example of guidance regarding qualitative standards that should be observed by large internationally active banks under Pillar 2. It would be helpful to the Associations if we can better understand why these

banks would not just utilize the Principles for the Sound Management of Operational Risk (PSMOR), which have been designed to apply to all banks.

*Too much focus on size in regulations*

The focus on size in the BCBS proposals also seems to unnecessarily pile up capital surcharges on the largest banks that are already subject to the G-SIB surcharge, the recently proposed TLAC requirement, as well as other capital regulations in their jurisdictions. Although each of these requirement is ostensibly addressing different issues, ultimately they all have a common goal which is to address the concern that large banks experience large losses in times of shocks; hence, the need to hold more capital to be more resilient. We believe that more capital is not always the answer and strongly believe that size is a poor proxy for systemic risk and overutilization of size as a distinguishing factor can gloss over large differences in the risk profiles of large financial institutions.

*Use of Euro-denominated size buckets*

The use of Euro-denominated size buckets may introduce FX volatility in capital requirements for banks headquartered in non-Euro jurisdictions. We respectfully request that the BCBS continue to look for ways to address this issue. At the least, we recommend that the BCBS publish a table of appropriate exchange rates to use for anchoring the look-up of capital coefficients for the range of currencies that apply in different jurisdictions. Another alternative is to convert each of the three years' BI from the local currency to the Euro using the average exchange rates for each year. We believe this is more aligned with accounting principles used to convert comprehensive income in once currency to the holding company's reporting currency.

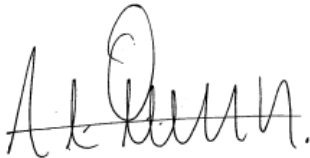
## Conclusion

In conclusion, while the Associations strongly support the Basel WGOR's objectives to addressing issues and weaknesses in the current simple approaches for operational risk with a goal of having a more robust operational risk regulatory capital framework, we believe there are changes that can be made to the proposals to make the new framework more risk sensitive than the existing one, and that the BCBS should take this opportunity to fully realize this objective. This is critically important given that the BCBS will assign enhanced roles to the standardized approaches to pursue its goal of striking a balance between simplicity, comparability and risk sensitivity in the Basel regulatory capital framework. In our view, feasibility of application to small, non-internationally active banks should not be a driving factor for limiting risk sensitivity and choosing too much simplicity. The Basel regulatory capital framework is intended for

internationally-active banks, which should be measured against higher standards.

We hope the BCBS will consider in its analytical work the suggestions presented in this letter. We offer again our support to this analytical work. We also respectfully request another round of discussions between the industry and the Basel WGOR before any changes to the existing framework are finalized. Should you have any questions, please feel free to contact the undersigned or Jermy Prenio of the IIF (jprenio@iif.com).

Best regards,



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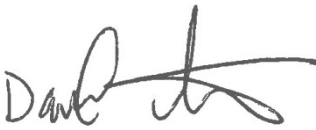

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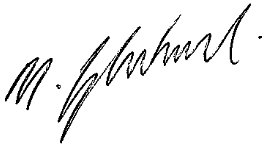

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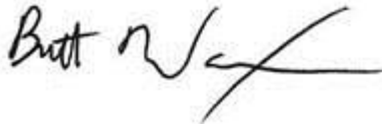

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