

June 3, 2016

Mr. William Coen
Secretary General
Basel Committee on Banking Supervision
Bank for international Settlements
CH-4002 Basel
Switzerland

Re: Standardised Measurement Approach for operational risk – consultative document

Dear Mr. Coen:

The Institute of International Finance (IIF) and the Global Financial Markets Association (GFMA) (the associations) appreciate the opportunity to comment on the Standardised Measurement Approach (SMA) for operational risk Consultative Document.

While the Associations support the overall goal of improving the capital treatment of operational risk, we believe the SMA as proposed will have a very significant effect on the system-wide quantity of operational risk capital and it will impact banks in many different ways that might not be related to the potential operational risks inherent in their business and operating model. We are aware of the time constraints the WGOR is under to finalize the revised framework and therefore this letter makes very concrete proposals on how to improve the SMA in a way that can be easily implemented in the final standard.

The associations note the basis for the decision taken by the Committee of withdrawing the possibility to use AMA. However, since the introduction of Basel II, many banks made tremendous efforts and investments to develop their systems and risk management practices for operational risk. This has been done in order to create sound internal models that reflect historical losses, changes into bank specific business models as well as future expectations; such features, in the banks' view, should also play a role for regulatory capital purposes.

Advanced models have many advantages, helping in assigning capital efficiently and supporting the evolution of the risk management practices of each institution (including ICAAP and Stress Testing), keeping the right incentives within institutions to actively manage operational risk, and helping in identifying future potential sources of risk. Additionally, they take into consideration a wide range of relevant information, including the use of scenario analysis and factors reflecting the business environment and internal control systems. In our view these other sources of information are relevant, as well as any mitigation plans and risk reduction measures (insurance or other effective hedging instruments).

Banks understand that operational risk is an integral part of their risk management frameworks, and its alignment with the regulatory capital planning is key to achieving consistency between internal cost and economic capital allocation in support of the business decision making process. However, capital requirements under SMA that lack risk sensitivity would in many cases be well above the economic capital banks have allocated to operational risk. This misalignment could open up undesirable room for arbitrage .

In this consultative document the proposed SMA considers size as the main driver of the capital requirement for operational risk, and a retrospective measure of risk sensitivity is introduced through the inclusion of historical internal losses. However, calibration of the SMA is not fully transparent and excessively high, size is unduly penalized and other sources of information have been ignored, all of which could result in a measure of risk not reflecting the real potential exposure of an individual bank. We understand and agree that risk sensitivity is one of several goals of the Basel Committee, and it has to be adequately balanced with the goals of achieving greater simplicity and comparability. However, the Associations believe there are improvements to the SMA that could help to better adapt it to different banks with different business models in different jurisdictions, even within the constraints of a “one size fit all” type of approach.

Quantitative impact and calibration

The Consultative Document (CD) makes clear that the objective of this proposal is to not significantly increase overall capital requirements, and the Committee has not articulated any general concern about the amount of capital currently allocated to operational risk in the banking industry as a whole. For this reason, and considering the recent operational losses in the banking sector, increase in capital requirements for operational risk of some banks could be expected, but a sector wide significant impact appears disproportionate and not in line with the overall GHOS mandate not to significantly increase capital requirements.

An initial assessment of the proposed rules shows that the outcome of SMA is an overall significant increase in the amount of capital to be allocated to operational risk across the industry, with material increases in some instances. This is not only the case for banks using AMA, but also for banks that are using any of the other methods available for measuring operational risk for regulatory purposes. This is shown in an impact study recently carried out by ORX (Operational Riskdata eXchange association) among its members, where 75% of the banks surveyed saw an increase in Pillar I operational risk capital under the SMA, with a median increase of 33% increase in capital needs and a mean increase of 61%.

This sharp increase in capital requirements is even more relevant for bigger banks in the higher BI buckets, despite the capital buffers that global and domestic SIB's already have in place, and without considering all the new regulations put in place to mitigate potential sources of operational risk. Regulations such as EMIR and MiFid that address market structure and transparency issues, and processes like stress testing, scenario analysis and supervisory reviews should overall result in a reduction of operational losses in the future. In our view, these developments directly reduce the relevance of past behaviour as an indicator to future operational performance and cannot be ignored in the calibration of the SMA.

From a more technical perspective, the SMA calibration has the following issues:

- SMA has been calibrated with an OpCaR model, which when aggregating top of the house loss data coming from various business lines and/or event types with different characteristics, ranging from “high frequency/low severity” to “low frequency/high severity” events, results in the aggregate frequency being dominated by the high-frequency/low-severity event types and the aggregate severity distribution being dominated by low-frequency/high-severity event types. This results in abnormal levels of capital requirements for many banks with significant amounts of **“high frequency low impact” type of losses that are very predictable, are provisioned for and are considered in the pricing and budgeting decisions.** They are generally managed as cost of doing business and should not attract significant amounts of capital. For these types of losses **a higher threshold for the LC should be established (of at least 100k).**
- Due to this limitation of the OpCaR model, it can be very unstable especially at high confidence levels. A reduction in the confidence level would help mitigate this issue.
- SMA has been calibrated with loss data information from the last QIS that is not complete. **The information of the current QIS should be used to recalibrate the charges.**

Volatility

As mentioned above, the SMA is not particularly risk sensitive, but it can be extremely volatile. When new large losses occur and/or when large historic losses drop off after ten years the levels of capital change significantly. This is not generally in line with real movements in the risk profile of banks, as a significant loss that occurred 9 or 10 years ago means very little in terms of explaining the actual risk profile of the bank, and this is undesirable for capital management purposes. Additional cliff effects derive from the mechanics of the thresholds, where a loss of 101 million is included 19 times, whereas a loss of 99 million is included “only” 14 times.

In particular, we suggest for reducing the volatility of the SMA:

- To make the calibration more robust and stable over time, **cap the extreme events (outliers) in the loss history by, for example, using a % of the BI.** Those events are individually managed and dealt with at the most senior levels of the institutions, and new procedures and controls are normally put in place, reducing the risk of similar losses occurring in the future. Those events would also be dealt with under supervisory Pillar II assessments.
- **Remove from the loss history losses that are less likely to repeat themselves in the future due to discontinued business/products or changes in law.**
- **Only the part of the loss that goes over a threshold should get the multiplier of the next tranche.**
- SMA treats all losses within the previous 10 years as equally relevant to the current risk profile of an institution, which might not be appropriate as banks will have likely changed their processes, product offerings etc. **We propose the introduction of a decreasing coefficient (i.e. linear discount factor of 10% each year) in relation to the ageing of the loss event.** This proposal (i) materializes benefits of the remediation actions and ii) would reduce the cliff effect in capital requirement produced when the large losses fall out of the 10 years slot.

Comparability

We agree with the Committee that comparability is an important goal if we want to achieve a good and sound framework, and this principle should also allow, to the extent possible for a standardized approach, to distinguish between different business models and product mixes. In this regard, we would like to propose some improvements to the framework:

- The proposed formula considers provisions as direct risk drivers in the BI Component (Other Operating Expenses). For this reason different accounting practices/GAAPs to provision for the same risk should be levelled, as well as the fact that some recurring highly predictable loss events attract much more provisions than unexpected isolated loss events. Therefore, **provisions for small, recurring expected losses for operational risk that have not materialized should be deducted from capital requirements.** To the extent that capital requirements are being calibrated including both expected losses (EL) and unexpected losses (UL), not recognizing those provisions that cover EL significantly penalizes banks that have high levels of EL and conservative provisioning practices.
- To ensure comparability in the application of the SMA, we suggest a **common definition of "loss" and that losses that do not pose real risk or losses that are covered by other risk types should be excluded.** We suggest to define "Loss" in the context of SMA as (i) net of direct recoveries (ii) excluding credit boundary events (iii) excluding timing losses (iv) excluding rapid recoveries within 5 working days.
- The **application and calibration of the 3.5% interest cap falls short in its objective of avoiding overly conservative capital for high NIM business models.** It has a limited impact on banks operating in countries with high net interest margin business models (including Brazil, Mexico, Russia, South Africa and Turkey). It also has a limited impact on banks that have high NIM business models along with other lower NIM business models. For example, assets that are held for ALCO or liquidity purposes (including sovereign debt and repos) can lower the bank NIM below the cap. This effectively increases the capital contribution of the bank's high NIM business activities and penalizes banks that hold more highly liquid, low risk positions. The NIM cap applied at the institution level also penalizes the high NIM businesses of banks with both low-NIM and high-NIM business models. A bank with a high NIM business that is part of an institution that is overall below the cap will have much higher incremental capital for its high NIM business than a bank that has a similar high NIM business and a NIM above the 3.5% cap. **Hence the cap to the interest component should only be applied to high NIM business lines/products.**

Simplicity

The Committee builds on the assumption that the SMA is a combination of a simple standardised measure of operational risk and bank-specific loss data that provides a sufficiently risk sensitive measure of operational risk, which at the same time reduces complexity and promotes comparability.

However, simplicity should not be an objective in itself, and should be carefully balanced with the other objectives of comparability and risk sensitivity. In this vein, considering that size is the main driver of the BI Component, simplicity could have some unintended consequences:

- Because the SMA has to be calculated both at **consolidated level and at entity level**, it could lead to a very significant difference between the consolidated and the aggregation of

sub-consolidated own funds requirements. Actually, **it does not make sense that the requirements for operational risk at consolidated level are much higher than the aggregation of the capital for the same risk calculated at each subsidiary level.** The way legal entities are organized in an institution should not affect capital requirements. Furthermore, it will raise management issues in large institutions:

- Either the extra capital arising at consolidated level is kept at this level, but then the monitoring of the business is disconnected from actual capital costs;
- Or the extra capital is allocated to the subsidiaries, but then it creates a counter intuitive and an uneven playing field at local level: entities belonging to large solvent group holding much more capital than local entities doing the same business with a smaller capital base.

One solution is to **cap this gap** and to **make the BI buckets much less progressive**, so that it helps compensate this effect. This could be achieved by narrowing the range between the lowest bracket and the highest one.

- Bank's size has not been used when defining the Loss component thresholds and it is clear that the same loss has not the same relevance for two banks of different sizes. Additionally, loss thresholds are overly sensitive to large loss events, and calibrated without justification; they often come from fines that are set at a level in line with the size of the institution, making the link between size and loss a self-fulfilling phenomena. Therefore the **proposed three tiered approach should be normalized for loss size relative to bank size.** One possibility could be to define the buckets as a % of the previous end of the year level of BI. This would also help to remove the sensitivity of the buckets, currently expressed in euros, to currency exchange effects.

Methodology

There are some important methodological issues we would like to bring forward, for some of which it would be useful to have more guidance:

- **More clarity on currency conversion to Euro is needed**, as both the amounts used in the BI and the LC are specified in Euros. For banks in non-Euro jurisdictions or with subsidiaries in non-Euro jurisdictions the main issues would be how to choose the appropriate exchange rates, what is the frequency of conversion and, above all, which currency conversion methodology should be applied that guarantees that the required SMA capital do not fluctuate due to mere exchange rates movements (e.g. if exchange rates are different from one reporting period to the next one, but the risk profile is the same...). This would require appropriate guidance.
- It is critical to extend the standardised formula to **recognise the risk mitigating effect of hedge mechanisms such as insurance** as is the case for market and credit risk. Doing so enhances the resilience of the financial system by leveraging the expertise and the capital of the insurance industry which is well placed to underwrite operational risks. It is possible to include insurance through an ex-post adjustment in a simple and transparent way. It should be applicable to banks of all sizes through the use of standard admissible insurance contracts. Such contracts will cover all operational risk events, only excluding coverage forbidden by law or against public policy. The ex-post adjustment can be determined using

pre-determined haircuts and will not require supervisory review of the calculations. It should alternatively be possible to exclude from the BI component the insurance capacity bought for particular risk events such as, for instance, property damage insurance.

Additional Considerations:

Even though we are aware of the time constraints that the Committee is under, we would like to take the opportunity to make some other comments relevant for the treatment of operational risk in the regulatory capital framework:

- The BCBS should consider the possibility to recognize under the SMA any financial instrument (not only insurance) that effectively reduce and transfer operational risk to the buyer of that financial instrument.
- The BI should capture differences in business models/lines, as they are relevant for operational risk purposes. This would be the case for example of two banks, one with a mortgage portfolio and another one with investments in sovereign debt. While both receive interest income, the first one bears more operational risk than the second. The same argument could be made for the same business model/lines but in different countries. Different parameters for different business lines as in the current standardised formula could be explored.
- Small entities in bucket 1 of the BI should be allowed to use the ILC to generate the incentives for them towards good risk management practices and to build and keep a good loss database. We suggest analysing an opt-in rule for smaller banks which allows the use of the ILC at least on application to their supervisor.
- SMA should include a forward looking view of the operational risk of banks through the consideration in the formula of Scenario Analysis. This could be done through the inclusion of forecasted financial information (budgets or stress testing base line scenarios) in the 3 year average calculation of the BI and in the 10 year information of the LC.
- The SMA appears to work by providing an “average” rather than a “minimum” level of Pillar I capital. Clarification is therefore needed on the role of Pillar II. An average Pillar I capital requirement suggests Pillar II would allow reductions as well as increases, enabling the overall capital framework to more directly differentiate changes in risk management practice.
- The BI calculation should include the deduction of the expenses needed to obtain the rental income from investment properties.
- The “fee-based” BI components should be calculated on a net basis in the same way as interest or leasing income/expenses and other operating income/expenses. This should avoid unintended impacts due to changes of international accounting requirements or different interpretation of those in specific jurisdictions and lastly strengthen a level playing field.

Conclusion

While the Associations remain concerned about the potential very significant effects that the proposed SA would have on the system-wide quantity of operational risk capital, we believe that meaningful improvements can be done in the final standard. To this effect, we are making specific recommendations that we believe can be easily adopted to improve the final standard to be produced by the BCBS. We remain at your disposal for further dialogue on this important issue.

As for the particular questions of the CD, please find our answers as an Appendix.

Sincerely,



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Institute of International Finance



David Strongin
Executive Director
Global Financial Markets Association

Q.1 What are respondents' views on the revised structure and definition of the BI?

In general terms, we agree with the structure and definition of the BI but we think that the BI Component is simply too high and too penalising, especially for bigger banks. As a summary of our main proposals already described in the introduction:

- Recalibrate the BI according to the new QIS data and using a lower level of confidence to make the SMA more stable, considering that size should not be overweighed.
- Make the BI buckets much less progressive to reduce the effect of "super-additivity" by narrowing the range between the lowest bracket and the highest one
- Review the 3.5% interest cap of the interest component of the BI so that it only applies to high yield products/business lines. Otherwise, its intended use could be diluted with other interest bearing products rendering the cap useless.

Q.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?

The Internal Loss Multiplier adds some loss sensitivity to the SMA, so from that point of view the inclusion of banks' specific loss data is positive, although the exclusive use of historical data does have its limitations. We summarize our comments to improve the methodology as follows:

- Recalibrate the BI according to the new QIS data and using a lower level of confidence to make the SMA more stable.
- Define the concept of "loss" in the context of SMA as (i) net of direct recoveries (ii) excluding credit boundary events (iii) excluding timing losses (iv) excluding rapid recoveries within 5 working days.
- The Loss Component should be revisited:
 - The proposed three tiered approach should be normalized for loss size relative to bank size. The ILM thresholds should be commensurate to the size of the institution, and one possibility could be to define the buckets as a % of the previous end of the year level of BI.
 - The "high frequency low impact" type of losses that are very predictable, are typically provisioned for and are considered in the pricing, budgeting, etc, should not attract capital. Consequently they should have a higher threshold in the LC (at least 100k).
 - Some losses should be reconsidered in the loss history:
 - Extreme events (outliers) should be capped for ILM calculation purposes.
 - Losses that are less likely to repeat themselves in the future due to discontinued business/products or changes in law should be removed from the loss history.

- Only the part of the loss that goes over a threshold should get the multiplier of the next tranche.
- Introduce a decreasing coefficient for losses in relation their ageing over the 10 year period, for example a 10% linear decay factor.
- Provisions for small, recurring expected losses for operational risk that have not materialized should be deducted from capital requirements.
- Extend the standardised formula to recognise the risk mitigating effect of hedge mechanisms such as insurance through an ex-post adjustment. Additionally insurance bought for particular events (for instance property damage or cyber-attack) should be excluded from the BI Component.

Q.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?

No comments on the above question.