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Strong banks – strong Australia

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Secretariat
Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
SWITZERLAND

Dear Secretariat

BCBS: Consultative Document: Standardised Measurement Approach for operational risk

The Australian Bankers' Association (**ABA**) appreciates the opportunity to provide comments on the Basel Committee on Banking Supervision (**BCBS**) Consultative Document: *Standardised Measurement Approach for operational risk* (**Consultative Document**).

With the active participation of its members, the ABA provides analysis, advice and advocacy for the banking industry and contributes to the development of public policy on banking and other financial services. The ABA works with government, regulators and other stakeholders to improve public awareness and understanding of the industry's contribution to the economy and to ensure Australia's banking customers continue to benefit from a stable, competitive and accessible banking industry.

In addition to responding to the specific questions raised in the Consultative Document the ABA takes this opportunity to provide additional feedback for the Committee's consideration.

Risk sensitivity

The Standardised Measurement Approach (**SMA**) has been designed under the BCBS's objectives of simplicity, comparability and risk sensitivity. However, the ABA does not consider that a balance of these objectives has yet been fully achieved in the SMA proposals. The ABA believes that risk sensitivity has been compromised in pursuit of simplicity and comparability. In particular, potentially significant elements of a forward looking risk profile are not reflected in the proposed formula (see our response to Q2 below).

The ABA also believes that a measurement approach that focusses solely on these three BCBS objectives, and which does not promote continuous improvement and best practice in operational risk management, is, in the long run, a detriment to the Basel framework.

The ABA's view is that the SMA leans heavily towards simplicity rather than risk sensitivity and does not encourage ongoing improvement in risk management practices. This may be an appropriate compromise for the broad spectrum of entities that will utilise the SMA, but it is not the optimum approach for all entities, in particular institutions with the ability, experience, modelling capability and data to develop a more risk sensitive approach as a result of their experience with the Advanced Measurement Approaches (**AMA**).

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A continued role for Advanced Measurement Approaches

A number of Australian banks have been accredited with AMA through the broader implementation of Basel II in 2008. It would be reasonable to state that Australian banks and supervisors would agree that Australia is one of a number of jurisdictions that has benefited from a successful implementation of AMA. The adoption of the forward looking AMA framework has driven investment and positive advances in operational risk management in the Australian jurisdiction.

The ABA is in agreement with the IBFed that AMA should continue to be part of the BCBS's operational risk framework. The ABA also agrees that existing AMA models should not be completely abandoned and the BCBS is encouraged to incorporate components of the AMA into the operational risk framework to further encourage continued investment in risk management expertise.

Implementation

The ABA welcomes the fact that the Committee intends to evaluate appropriate implementation arrangements and will provide sufficient time for implementation, taking into account the range of other related reforms that have been, or are due to be, agreed.

National supervisors will need adequate time and flexibility to understand the interconnected nature of these international and domestic regulatory reforms to avoid unintended consequences and unnecessary costs. This is particularly relevant given the expected increase in capital under the proposed approach. The ABA also considers the increased SMA for capital requirements should be phased-in over several years.

ABA response to BCBS questions

Q1: What are respondents' views on the revised structure and definition of the Business Indicators (BI)?

The ABA understands the principles of the BI, however, to avoid misinterpretation and ensure comparability across the industry and jurisdictions, some of the definitions that underpin the formula require further clarification. For example, in some instances the definition contained within the BI differs from accounting standards creating challenges in extracting the data from the finance systems. To resolve this, the ABA recommends that consideration be given to aligning names and definitions to those in accounting standards. Differences in accounting standards internationally should also be considered to ensure comparability, therefore the ABA recommends that the BI components align to both the International Financial Reporting Standards/International Accounting Standards (**IFRS**/**IAS**) and US' Generally Accepted Accounting Principles (**GAAP**) to ensure harmonisation.

Q2: 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 ABA is supportive of the inclusion of loss data in the SMA to incorporate greater risk sensitivity into the formula, rather than the BI alone. However, as with BI definitions, further clarification is required of the definitions and treatment of losses. For example:

1) **The treatment of corporate restructures** (i.e. the inclusion of losses from new acquisitions and exclusion of losses from discontinued businesses). The ABA proposes that in order to provide an appropriate linkage between capital and an organisation's actual risk profile, losses from new acquisitions should be included in the SMA calculation and losses from discontinued businesses excluded.

For example, if a domestic bank sold an overseas subsidiary and had no residual liability for either past or future operational risk events as a result of the sale, then the overseas subsidiary should be removed from both the BI and loss components of the SMA calculation. If a domestic bank exited a part of a business or business line then any adjustment to the data to more accurately reflect the actual risk profile would be via consultation with the local supervisor. The local supervisor would consider the impact of the change in the risk profile implied by the divestment and the extent of ongoing liability and/or exposure to future losses. This increases risk sensitivity of the SMA by ensuring capital requirements reflect a bank's current risk profile, and the risks it faces going forward.

2) **Local regulator discretion**. Further to the above, the ABA recommends that the standards should allow national discretion to apply judgement in determining the losses that should be included, excluded, or adjusted for SMA purposes. This would provide the supervisors with the ability to determine which losses are relevant to the bank's current risk profile and which losses should be excluded, or reduced to reflect actual risk faced by the business (i.e. the regulator may exclude or reduce the impact of losses if they are no longer relevant to the bank going forward, or if risk management has improved so as to reduce the risk of re-occurrence). This would go some way to addressing the linkage of measurement and management of operational risk.

3) **The treatment of 'rapid recovery' for large payment errors**. As per the Supervisory Guidelines for the AMA, the ABA recommends that when the recovery is made rapidly, the bank may consider that only the loss net of the 'rapid recovery' constitutes an actual loss. When the 'rapid recovery' is full, the event is considered to be a 'near miss'. This will reduce the significant volatility in the SMA capital requirements which may arise due to large but low risk payment errors, which may not have posed any risk to the firm other than the credit risk of counterparty default.

4) **Definition of losses**. The Supervisory Guidelines for the AMA state that "losses with a common operational loss event should be grouped and treated as a single loss". Clarity is required as to whether this approach applies to the SMA and the treatment of common loss events across different business lines and geographical locations. Consistency is also required between different jurisdictions on the definition and treatment of boundary events.

In addition to the above there are also a number of definitional issues that should be clarified prior to the adoption of the SMA. For example, consistency of the date used and clarity as to the treatment of boundary events and operational risk gains.

Concept of a ten year loss window

The ABA supports the concept of a ten year loss window, however, the ABA is concerned about the volatility in capital when large loss events drop out of the window, referred to as the 'cliff effect'. To address this, the ABA recommends either replacing the three separate loss averages with a progressive multiplier such that an increasing weighting applies to the portion of the loss greater than the relevant thresholds (i.e. 19 times weighting for portion of losses greater than EU100 million).

The ABA proposes that loss data should reflect all recoveries, including insurance, to reflect actual experience and increase the risk sensitivity. The ABA believes this is important from a comparability perspective. If two banks with similar risk profiles have the same profit and loss impact from net loss experience, then the SMA outcome should be consistent. This may not be the case in the current SMA calculation which utilises gross losses. The ABA understands that there may be concerns that banks may change their insurance coverage to engineer more positive capital results. This can be monitored by supervisors either qualitatively or through analysing loss data.

Q3: 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 assessing the alternative SMA methodology against the three stated objectives, it is the ABA's view that it is not significantly better or worse than the proposed log based factor.

Additional feedback

Further to our specific responses to the stated questions, the ABA would also like to take the opportunity to provide some additional comments.

Promotion of sound risk management practices

The ABA believes that the promotion of the linkage of measurement and management of operational risk is so fundamental that encouragement of sound risk management practices should be included as a fourth objective of the SMA. The ABA does not suggest rewriting the SMA at this stage to address this, however, any further amendments to the SMA should include this additional objective.

Allocation of capital

The SMA document does not give any details as to how capital for wholly owned subsidiaries will be allocated. The current SMA formula is not designed to be an additive between outcomes at a group level and the subsidiaries. Greater guidance on this element would be appreciated. The ABA believes that this issue also provides an opportunity to include principles for risk sensitive allocation of capital from the group level which would preserve the comparability properties of the SMA, but would also support the promotion of risk management.

Unintended consequences

Noting the BCBS's goals of simplicity and comparability, the ABA believes the introduction of the SMA will have a number of unintended consequences which could include:

- Resources being devoted to managing data rather than focusing efforts on risk mitigation and management.
- The loss of staff and experience to other risk disciplines.
- A decline in future funding and interest for academic research on operational risk.
- Fewer advances in techniques for assessing forward looking extreme risks and deeper analysis of the drivers of these events.

Threshold currency conversion

The ABA would welcome clarity on how local regulators should convert EU thresholds to local currency. The ABA expects APRA will have its own comparable thresholds, however, principles need to be clarified to ensure global consistency. The ABA recommends that buckets should be converted to local currencies at a fixed rate. Ideally, once this rate is published by the local supervisor it should remain static for an agreed time period, particularly through normal currency market cyclical fluctuations.

The ABA notes that the insurance industry is currently formulating ways to include insurance mitigation within the SMA formula. The ABA supports this concept if it reinforces the objective of encouraging sound risk management practices through effective risk transfer. The ABA encourages the BCBS to consider amending the final SMA standards to allow for globally approved insurance products where it can be established that payment would be certain and where it's possible to determine a standard capital haircut.

Conclusion

The ABA believes that the balance between the BCBS's objectives of simplicity, comparability and risk sensitivity has yet to be achieved within these SMA proposals. Risk sensitivity has been compromised in pursuit of simplicity and comparability. The ABA believes further work is required to accurately calibrate the level of capital for operational risk.

Given the ongoing challenges and debate in relation to measuring operational risk, the ABA encourages the BCBS to continue engaging with industry in relation to both future refinements to the SMA and the calibration of the operational risk capital framework.

Thank you for taking our comments into consideration – the ABA looks forward to future discussions on this issue.

Yours faithfully

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