



Institute
and Faculty
of Actuaries

Standardised Measurement Approach for Operational Risk

IFoA response to the Basel Committee on Banking
Supervision

3 June 2016

About the Institute and Faculty of Actuaries

The Institute and Faculty of Actuaries is the chartered professional body for actuaries in the United Kingdom. A rigorous examination system is supported by a programme of continuous professional development and a professional code of conduct supports high standards, reflecting the significant role of the Profession in society.

Actuaries' training is founded on mathematical and statistical techniques used in insurance, pension fund management and investment and then builds the management skills associated with the application of these techniques. The training includes the derivation and application of 'mortality tables' used to assess probabilities of death or survival. It also includes the financial mathematics of interest and risk associated with different investment vehicles – from simple deposits through to complex stock market derivatives.

Actuaries provide commercial, financial and prudential advice on the management of a business' assets and liabilities, especially where long term management and planning are critical to the success of any business venture. A majority of actuaries work for insurance companies or pension funds – either as their direct employees or in firms which undertake work on a consultancy basis – but they also advise individuals and offer comment on social and public interest issues. Members of the profession have a statutory role in the supervision of pension funds and life insurance companies as well as a statutory role to provide actuarial opinions for managing agents at Lloyd's.



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

3 June 2016

Dear Sirs

**IFoA response to Basel Committee on Banking Supervision: Consultative Document
Standardised Measurement Approach for Operational Risk**

1. The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to respond to the Basel Committee on Banking Supervision's (BCBS) consultative document on Standardised Measurement Approach (SMA) for Operational Risk. The IFoA's Risk Management Board has had responsibility for drafting this response. Under that Board's oversight sits the IFoA's Operational Risk Working Party, which has contributed much of the content of the response.

General Comments

2. The IFoA is disappointed the Committee has decided to discard the Advanced Measurement Approach (AMA). Our disappointment is for the following reasons:
 - Many banks have invested considerable resources in developing plans to meet the requirements for AMA approval;
 - There will be no regulatory capital benefit from this investment;
 - The withdrawal of the AMA will probably reduce investment in risk modelling which, in turn, may have an adverse effect on risk management; and
 - This decision removes an element of flexibility from the regulatory capital regime, particularly where standardised requirements are not proportionate.
3. One example of where retaining AMA could have provided regulatory benefits would be for banks, with high net interest margins and/or fees, which would have had no need to introduce further adjustments to an already complex calculation.
4. The IFoA agrees with the Committee's view that the variability of modelling approaches adopted for AMA could exacerbate the variability of Risk-Weighted Asset (RWA) figures for operational risk. We believe, due to the idiosyncratic nature of operational risk, there will always be variability in the underlying operational risk exposures. These will vary in accordance with different business models and control frameworks. The operational risk exposure of a global private bank catering to high net worth clients will be different from a retail bank operating within one particular country. Naturally both of these different banking models will differ significantly from an investment bank.
5. From our explanation in paragraph 4, we would question whether a single standardised approach would be appropriate for all banks, even with the adjustments made to the SMA in

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the consultative document. These adjustments add to an already complex calculation. Such complexity does appear to be in opposition to the Committee's desire for greater simplicity in assessing regulatory capital (paragraph 7 of the consultative document). While the Basel II standardised approach (TSA) was a crude measure, users could understand it more readily in terms of percentages of gross income. The SMA will be much more difficult to communicate to boards and other stakeholders.

6. Operational losses can take many years to emerge. Basing regulatory capital requirements, in part, on historic losses could lead to banks holding capital in respect of legacy exposures which are no longer relevant.
7. As an example, UK banks would have to hold significant regulatory capital in respect of mis-selling Payment Protection Insurance (PPI) long after exposure has run off. This capital would not be required as banks will have compensated customers, or the statute of limitations will apply to time-bar further claims. Furthermore, capital charges based on legacy losses may not capture changes in risk profile arising from changes in the bank's business model and/or the control environment. This approach would also fail to identify new risks emerging, such as cyber risk.
8. As historic loss data may not capture changes in risk profile, as discussed in the previous paragraph, there is a need for a forward-looking perspective. We believe scenario analysis could provide such a perspective. While it is probably too subjective to be incorporated in Pillar I regulatory minimum capital requirements, we would commend the approach of the UK Prudential Regulatory Authority (PRA) of reviewing scenario analysis results as part of the Pillar II supervisory process.
9. We note the final calibration of the SMA will require the Committee to undertake a QIS. We believe that aggregate operational risk capital requirements will need to increase significantly from Basel II requirements. Although hindsight can offer a misleading assessment of past risks, TSA capital requirements have proven inadequate in light of PPI mis-selling, LIBOR fixing and other operational losses.
10. We strongly believe these operational failings may have compromised AMA models and wider operational risk management. Models which produced significantly higher requirements than TSA would have been rejected. It is likely scenario analysis would also have been rejected, even if such analysis was borne out by events, if it had suggested potentially higher losses than envisaged by TSA. Consequently, we believe regulatory capital requirements should be increased significantly.
11. While it is possible to attribute many operational losses, like credit and market losses, to excesses in the run-up to the financial crisis of 2007/09, there may be a more tenuous connection to other losses (such as the IT systems outage experienced by RBS). Consequently, there may be a case for allowing for diversification between operational risk and credit and market risk requirements. This would lead to higher marginal operational risk requirements for banks with relatively less credit and market risk, such as those with a wealth management focus, or those with an "originate and distribute" model. However, this may be appropriate given that operational risk may be more significant for such banks.
12. We acknowledge that the structure of larger banks may be more complex, which could have an impact on operational risk exposure. We would welcome more empirical evidence for the progressively increasing Business Indicator (BI) related charge. We would note that a large institution with diverse operations might be able to withstand a single large operational loss

event. A similar event for a smaller bank could prove fatal to its future operations. Given that some operational loss experience may be very immature in terms of emerging risks (e.g. cyber risk), there may also be a case for adopting a similar BI percentage for smaller banks.

Q1. What are respondents' views on the revised structure and definition of the BI?

13. We believe the BI calculation is unduly complex and is not intuitive. In particular, we would challenge the adjustments for banks with high net interest margins and fee components and the underlying assumption that otherwise regulatory capital would be too conservative. It is not clear whether the particular business models that allow these banks to earn high margins and fees introduce a greater exposure to operational risk.

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?

14. We emphasise again that the historic loss component is not intuitive, appears unduly complex and could be subject to "over-fitting" to loss data. More generally, historic loss data may not be a good predictor of future operational risk exposure for the following reasons:

- They may no longer be relevant e.g. PPI losses mentioned in paragraph 7;
- They may not reflect changes in a bank's business model, or its control framework;
- New risks, such as cyber risk, might not have emerged fully in loss experience;
- Different levels of loss could be down to chance. e.g. IT problems could cause a loss for one bank, but generate a "near miss" for another bank; and
- A bank that has suffered a previous operational loss may strengthen controls and be less susceptible to future operational risk.

15. As noted in paragraph 8, as part of the Pillar II supervisory review, we would recommend the collection and review of scenario analysis data in a similar fashion to the UK PRA's Pillar II approach to operational risk.

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?

16. Our only comment is the overall calculation is extremely complex. The complexity makes the communication to a non-technical audience of operational risk capital requirements, much more challenging.

17. Should you wish to discuss any of the points raised in further detail please contact Matthew Levine, Policy Manager (Matthew.Levine@actuaries.org.uk / 0207 632 1489) in the first instance.

Yours faithfully



Colin Wilson
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