afme/ Finance for Europe

Association for Financial Markets in Europe

Operational Risk

Pre-CRR3 position paper

July 2019

Key messages

- **EU-level for national discretion:** While the international standard provides national level discretions, AFME and our members prefer that discretions are adopted and applied consistently across the EU. Having a clear set of uniform rules and technical standards developed by the EBA across the Single Market is essential for the integrity of the market and for a level playing field.
- **Leave ILM variable but capped at 1:** In order to address the deficiencies in the loss history based ILM approach, we recommend a variable ILM, but capped to a value of 1. This would allow for:
    - Supervisors to focus on current and future operational risks faced by banks through a comprehensive forward-looking assessment, including non-financial/unknown risks and bank specific likelihood of tail losses, instead of applying capital charges based, to a large extent, on past losses;
    - EBA to develop harmonised standards for operational loss events identification and recording, facilitating greater historical loss comparability for Pillar 3 reporting purposes across banks; and
    - Banks with low historical losses to still benefit from their lower operational risk profiles, which will maintain the capital incentive under the standard in quantifying Pillar 1.

- **Comprehensive Pillar 2:** Given the shortcomings of the Standardised Measurement Approach (SMA)[1], the EU should consider a comprehensive Pillar 2 framework for operational risk. This framework would have to be well defined through Level 1 text and an EBA RTS mandate, as appropriate, in order to ensure that supervisors and banks have the tools to address operational risks appropriately and consistently. Transparency and objectivity of the criteria should ensure that the Pillar 2 framework does not result in uneven playing field within the EU and, in comparison, to other jurisdictions.
- AFME also believes that it would be helpful if the EU implementation of the operational risk Pillar 3 disclosure requirements was aligned with the final BCBS standard[2] to ensure proportionate disclosures that are consistent with those of other jurisdictions. In particular, disclosing any provisions against pending litigations and settlements should not be required as it could raise confidentiality concerns.

[1] [1]For background, see https://eba.europa.eu/documents/10180/2259345/EU+banks+journey+towards+an+enhanced+capital+framework++-+March+2019.pdf

[2] https://www.bis.org/bcbs/publ/d432.pdf

Feedback on EBA's advice

AFME and our members agree that recent past losses are an indicator of potential future losses and historical losses are widely used in internal operational risk models. However, we oppose the EBA's recommendation that the loss component be quantified on the basis of 10-year long loss history, which then becomes the primary determinant of operational risk capital through the application of the Internal Loss Multiplier (ILM).

Our members and academic literature, such as Curti and Migueis[3], believe that the information value of past losses, as predictors of future losses, reduces significantly as such losses become older than three years and that the frequency and severity of losses as indicators of potential future exposure behave differently. While recent loss frequency data and changes in average frequency perform better as future loss indicators, the severity component is more volatile (for example, due to large conduct related fines) and thus is a less reliable indicator. Curti and Migueis observe that treating frequency and severity separately results in better information of likely future losses compared to relying solely on past loss totals, as the ILM does. As the ILM and the underlying loss component draw on loss history of such extended duration and, therefore, of reduced information value, we recommend that the ILM component be capped at 1 and reviewed by the Basel Committee of Banking Supervision (BCBS) to maintain international consistency and to improve the risk sensitivity of the international standard.

Given the shortcomings of SMA[4] and to underpin the Pillar 1 capital requirements, the EU should instead consider a comprehensive Pillar 2 framework, as noted above. The framework should be well defined in the Level 1 text and through an EBA RTS mandate, as appropriate, to ensure that supervisors and banks have the tools to address operational risks more appropriately and consistently. The framework should appraise the approach to emerging risks, such as cyber and non-financial risks, which supervisors are increasingly focused on. Transparency and objectivity of the criteria would ensure that it does not result in uneven playing field with other jurisdictions.

Additional considerations

The Standardised Measurement Approach (SMA), developed by the Basel Committee on Banking Supervision (BCBS) will replace all existing regulatory approaches in determining Pillar 1 capital requirements for operational risk. In particular, upon SMA's introduction, banks will no longer be able to use internal models to measure their operational risk capital requirements for Pillar 1 purposes.

AFME's global affiliate the GFMA, together with the IIF, provided our feedback during the BCBS consultation process, highlighting how the proposed framework could be improved in various areas, such as better recognition of insurance protection and the use of a forward-looking risk component. However, we are supportive of the EU adopting the Basel standard and our comments on adoption of the rules relate to (a) the supervisory discretions available in the global standard and how they should be applied in the EU, and (b) some further operational concerns discussed further below.

[3] The information value of past losses in Operational Risk, April 2019: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3353446

[4] [4]For background, see https://eba.europa.eu/documents/10180/2259345/EU+banks+journey+towards+an+enhanced+capital+framework++-+March+2019.pdf

Several remaining issues relating to the international standard, which should be carefully considered in the European implementation as well as in the wider Basel process, include:

- The operational risk standard developed by the BCBS focuses on past concerns as it solely relies on a size-based historical financial data metric and past operational risk losses to determine the amount of regulatory capital to be set aside for potential operational risk losses in the future.
- The Internal Loss Multiplier (ILM) is based on past loss history and does not necessarily capture the operational risks that many of the supervisors are increasingly concerned about, such as cyber, technology, fraud/unauthorised activities and operational resilience.
- The ILM is also subject to volatility that can result in significant changes to the SMA operational risk capital requirements when large losses, due to, for example, regulatory fines, roll off the loss history. Finally, the standard's focus on past losses over a 10-year historical period provides little incentive for banks to change behaviour or innovate in the short- to medium term due to a missing link to risk management.
- There are also concerns that recording of operational losses is not standardised across the industry. The new framework's strong link to past losses cannot prevent further divergences amongst firms in recording and disclosing losses, leading to uneven playing field and divergences in capital measurement against otherwise similar levels of operational risk.
- To compensate for these weaknesses in the BCBS framework, significant supervisory discretions are provided in the BCBS operational risk rules, compared to the BCBS standards developed for credit and market risks. These discretions can lead to significant divergences across jurisdictions in the SMA's application and its results.
- In addition, as noted, the operational risk framework under the SMA separates from other risk categories by not recognising any forward-looking risk mitigation, such as insurance. The industry considers that the lack of forward-looking risk mitigation in the new standard is a flaw that could hinder the effectiveness of operational risk management and measurement.

  Applying an insurance scheme has multiple positive aspects and allows for the pricing of operational risk against a protection-selling third party with opposite economic incentives. The standard's recognition of insurance recoveries in netting past operational risk losses does not address the above-mentioned deficiency as it results in only past losses and recoveries being considered rather than taking into account the risk transfer allowed by an effective insurance framework. Hence, we recommend that the treatment of risk mitigation be revisited as part of the EU and global legislative processes.

Background to SMA

The SMA methodology calculates the Pillar 1 capital requirements by using a measure of banks' Profit and Loss (P&L) to arrive at a size-based metric (Business Indicator, or BI). The BI is comprised of the sum of the following P&L items based on financial data for the preceding 3 years:

1. <u>Interest, Lease and Dividend:</u> Net Interest + Dividend Income;
2. <u>Services Component:</u> Other Operating Income or Expenses + Fee Income or Fee Expenses; and
3. <u>Financial Component:</u> Net P&L for Trading Book + Net P&L in Banking Book.

Using threshold Bucket-related conversion factors, the BI is turned into a BI Component before being multiplied by the Internal Loss Multiplier (ILM), which is a function of the ratio between the Loss Component (LC) and the BI Component; the higher the ratio is, the higher the Multiplier is. The LC itself is based on bank specific historical operational risk losses over a rolling 10-year observation period. The resulting equation (BIC x ILM) penalises P&L size and past loss experience, irrespective of changes to the bank's business model and operational risk profile.

As defined by the BCBS, the SMA will have a significant effect on the system-wide quantity of Pillar 1 operational risk capital in Europe, and it might misrepresent the potential operational risk inherent in banks' business and operating models as it looks only at size-based metrics and past experience to determine a forward-looking operational risk capital requirement.

Separately, the BCBS rules provide significant supervisory discretion that can lead to materially different outcomes for banks with the same operational risk profiles across jurisdictions. The supervisory discretions are summarised below:

1) The minimum threshold for including a loss event is 20,000 Euros and a national discretion to raise that threshold up to 100,000 Euros;
2) Subject to supervisory approval, there is a possibility to exclude certain operational loss events that are no longer relevant (i.e. settled legal exposures and divested businesses). While these exclusions must be disclosed in Pillar 3, their ad-hoc elimination in the case of some banks, but not others, could have a material impact on Pillar 1 comparability; and
3) Most importantly, the ILM component can be applied differently, depending on supervisory discretion:
    - At national discretion, supervisors may allow the inclusion of ILM for banks in Bucket 1.
    - At national discretion, supervisors may set the value of ILM=1 for all banks in their jurisdictions, thus removing the impact of the Loss Component in the capital calculation.

This level of discretion is unprecedented in the BCBS standards. Such national and supervisory discretions are unhelpful in the context of EU and broader global implementation which should aim to achieve a level-playing field and consistency in the adoption and execution of prudential standards.