FÉDÉRATION BANCAIRE FRANÇAISE

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FRENCH BANKING FEDERATION RESPONSE TO BCBS 2nd CONSULTATION ON REVISIONS TO THE STANDARDISED MEASUREMENT APPROACH FOR OPERATIONAL RISK

The French Banking Federation (FBF) represents the interests of the banking industry in France. Its membership is composed of all credit institutions authorized as banks and doing business in France, i.e. more than 390 commercial, cooperative and mutual banks. FBF member banks have more than 38,000 permanent branches in France. They employ 370,000 people in France and around the world, and service 48 million customers.

I- General comments and Overview

The FBF welcomes the opportunity to respond to the Basel Committee's second consultation on the Standardised Measurement Approach for operational risk (SMA). We grant the Basel Committee for having taken into account some of the comments made by the industry further to the first consultation such as the treatment of leasing and introduced more risk sensitivity, however we regret that the Basel Committee has not reintegrated the segmentation by business lines, as it was asked in our response to the first consultative document.

Our main concern relates to the fact that we do not share the Basel Committee's view that post-crisis reforms aiming at completing Basel III rules will not lead to significant increase in capital requirements for banks. For operational risk notably it seems that the SMA will result in higher capital requirements for nearly all banks, and especially AMA banks like French banks, which are for the main part currently using the Advanced Measurement Approach.

We clearly think that one of the major weakness of the SMA, as it is, is implicitly to consider that the bigger the bank is (in relation to its Business Indicator - BI) the more systemic it is, and consequently more capital for operational risk should be required. On one hand operational losses are not linked to the size of banks, and on the other hand systemicity is already tackled by various regulatory reforms. This pleads for a deep re-calibration of the current SMA proposal.

In a nutshell, although the Basel Committee's objective with this proposal is not to significantly increase overall capital requirements, we consider however that:

- **the SMA still comes up with a significant increase of the level of capital requirements for large banks that appears excessive**, especially given other schemes validated or considered (additional requirements for G-SIBs, TLAC, review of approaches for other risks, …) and given that all in all, key risks for a bank that should drive prudential requirements should be credit, market or liquidity risks.
  We ask that a cap on operational risk capital requirement is to be considered in order to avoid additions of prudential buffers. It would be to exclude operational risk capital in excess of 15% of BI or the gross income[1] from all regulatory buffers (SIB, CCB, and SRB) in order to avoid duplication of systemic risk requirements.

- **The framework does not value at all initiatives taken by each institution in order to remediate, prevent or transfer operational risk**. For tackling this particular concern, we make several proposals.

Our answer to Q1 and Q2 develops the following keys messages and proposals, which you will find hereafter:

- **The overall calibration of the SMA should be reviewed in two directions: ensure a much more limited increase in the global operational risk capital requirement and reduce progressivity of the framework to size or large loss events.**
  It maybe evidenced that losses are more important in large institutions. However,
  - losses such as fines are more and more based on the size of the institution (such as a percentage of the NBI or even NI), making the link between size and large losses a self-fulfilling phenomenon;
  - When facing a material loss, large institutions have the required resilience when small ones do not. It appears counter intuitive to have too wide a difference for a same institution, depending if operating on a standalone shareholding basis unit or being able to rely on a large group.

  We suggest Loss Component (LC) threshold to be commensurate to the size of the institution and that the progressivity to size in the BIC and in the LC be reduced, by reducing the different coefficients of the BIC and the LC.

- **Sensitivity to losses should be fair, with no double impact, and economically meaningful, with a specific treatment of divested activities and outlier events**.
  Divested activities should be simply removed from the scope, and extreme losses originating from outlier events should be capped to X% of the BI, let's say 500 bps.

- **As a general principle, being sensitive to actual losses is not enough; the framework should foster mitigation actions by banks, either by remediation or by transfer of the risk**. We propose hereunder different adjustments of the proposed formula in order to better reflect this more dynamic and virtuous approach.

[1] 15 % on the gross income is the actual coefficient for the Basic approach and as such would be consistent with the BCBS target of not increasing capital requirements.

II- Answer to questions related to the consultation

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

We strongly advocate for reducing the progressivity of the Business Indicator Component (BIC)

The overall calibration of the BIC appears to give an excessive importance to size and we regret the lack of explanation on its calibration. If we may agree that large and complex institutions may have a higher exposure to operational risk, it is surely not of the magnitude assessed. We strongly advocate for reducing the progressivity of BIC buckets.

- **In this respect, we suggest the range between the lowest bucket and the highest one should be narrowed to a maximum of 50 % which is already a very conservative assessment of complexity of large institutions.**

The removal of any approach that distinguishes business models as results from the BIC lead to counter intuitive situations with increase in areas with low loss levels and relative decrease in areas the most severely exposed to large losses (see our answer to 2014 consultation with a proposal for having three major business lines, being retail banking, wholesale banking and investment management). **We consider that the BI unduly favours jurisdictions characterized by high level of disintermediation, which is clearly not suited for the European Union.**

We propose to improve the BI calculation methodology

The SMA BI calculation could be improved in order to avoid double impact. The BI should not take into account the operational risk losses that are already dealt with through the LC. Otherwise, institution would be subject to a complementary capital charge both via the BI for three years and via the LC for ten years.

- **Operational losses should not be taken into account in the calculation of the BI[2].**
    - The BIC should be calibrated to reflect the medium term operational risk profile of an institution (which is not linked to operational risk events impacting the last three years) when the LC captures the deviation from this medium term profile in the recent years (actually ten years in the current proposal)
    - By doing so, this would avoid any double impact of operational risk losses in the calculation of the operational risk capital requirement;

[2] In the current proposal, we understand that operational losses should be added to the "other operating expenses" items, whatever their accounting treatment (other operating expenses or not). This point needs to be clarified.

- This would also address the netting issue of Operating income and Operating expense addressed in §15 of the consultation : not taking in account the operational losses in the calculation would ensure that in case of netting, such losses cannot result in a decrease in operational risk capital requirements.

- **We also propose to net income and expenses in the service component, or at least to remove the cap specifically introduced in the Service Component calculation for banks with share of fees greater than 50% of unadjusted BI**, as it provides incentives for banks to concentrate on activities generating fees (subject to the cap). Indeed at a given level of activity, a diversified bank would be subject to more operational risk capital requirements, than a non-diversified bank.

- Finally, in order to ensure a level playing field with others jurisdictions, particular attention should be paid on differences in accounting standards notably between US GAAPs and IFRS, as the SMA measures operational risk based on accounting figures.

<u>Some risk management actions, such as insurance, should be made deductible from the BIC</u>

- **Provisions for operational risk should be made deductible from the BIC in order to avoid double counting**: if a reserve is set through a provision, institutions do not need another one buffer through capital. This would recognize good risk management practices within institutions which develop proactive provisioning policies.

- **Insurance policies subscribed by institutions are an important risk mitigant in terms of operational risk management and should thus be better recognized**.

We believe that the incorporation of insurance within the Pillar I operational risk framework should be robustly and consistently addressed. In earlier papers – most notably recognising the risk-mitigating impact of insurance in operational risk modelling (BCBS, October 2010) - the Committee has clearly acknowledged the efficacy of insurance in mitigating operational risk losses. Clear guidance was provided as to the criteria to be fulfilled by an insurance policy for it to be admissible as part of the capital structure which might be set against the operational risk capital requirement.
Moreover, insurance is a source of stability in the banking prudential equation:

- Insurance is a non-correlated source of long-term capital which has proven itself stable over several cycles
- In difficult times – especially for European banks – insurance taps into capital which is not exposed to maturity transformation, and thus adds stability to bank funding
- The process of insurance underwriting is a review of the bank's people, processes, systems and governance. As such, it serves as a support and validation of supervisory review.
- The pricing and availability of insurance is driven by the quality of the bank's risk management. As such, insurance serves to mark the cost of operational risk to market.

We consider that the capacity bought on the market is a relevant indicator of a proactive and forward looking risk management practice. It should be made deductible from the BIC. This is especially relevant for insurance policies which cover risk such as building destruction[3] or cyber-attacks.

Unintended consequences linked to the Scope of application and risk of super additivity of capital requirements should be addressed

Regarding the SMA perimeter, the point 4) of the proposal states that the SMA must be applied by international banks. However, paragraphs 37) 38) and 39) seem to widen the scope to all institutions. Thus, as in the first consultation, a doubt remains on the level of implementation of the SMA for banking groups.
If the SMA has to be declined both at consolidated level and at entity level, this mechanism could lead to a 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 have a key effect on 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 it is allocated to the subsidiaries, but then it creates a counter intuitive and an uneven playing field at local level because entities belonging to large solvent group being much more capitalized than local entities doing the same business with a smaller financial surface shareholding.

We propose the following recommendations in order to address the inconsistency between solo and consolidated capital charges:

- **Limiting the progressivity of the overall framework as advocated above would help to limit this bias.**

- **We propose furthermore to define a cap between the capital requirement coming from adding up standalone requirements and the one coming from direct calculation at consolidated level**. We suggest setting the cap at 20 %.

- **Finally the FBF does not agree that bucket 1 banks should be exempted from the ILM**. We consider that if the minimum criteria prescribed to use it (on sections 6.1 and 6.2) are observed, **the bank should be able to adopt the multiplier, regardless of the bank's BI size.**

[3] Is it relevant to hold capital for a building destruction when this is a risk that is properly and reliably insured.

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?

As a preliminary comment it will be appropriate to review and homogenate the operational losses perimeter and definition, still sometimes inconsistent between jurisdictions. Furthermore, losses should be clearly taken into account as net of any insurance recovery.

The proposed approach with three brackets makes sense as its helps to differentiate capital requirements for high frequency events vs high severity ones, what a single bracket don't do. However it is highly based on losses experience which, over a period of 10 years, does not consider actions from an institution to improve its risk and control management framework. This is especially detrimental in the case of extreme losses coming from outlier events.

<u>We propose the following adjustments to the loss component (LC) :</u>

- **Losses relating to divested activities must be removed** from the losses and the ILM calculation because such losses are not relevant and cannot occur anymore.

- The LC is determined by adding several average total annual loss above fixed thresholds (0€, 10M€, 100M€). **The thresholds should be commensurate to the size of the institution**. A 100 M€ loss does not have the same impact and meaning when occurring in a small bank or in a large institution. **Brackets should be defined as a % of the previous end of the year level of BI or CET1.** This would help also to remove any sensitivity of the brackets, currently expressed in euro, to Forex effects.

- **Effects of remediation plans should be introduced specifically for large loss events:**

  - **Through a discount factor on ageing losses,** just after a large loss, the institution may suffer an increase in capital. If things do not reproduce in the following years, this materializes benefits of its remediation actions and this should be accounted for through a linear discount factor of 10% (if spread out on 10 years) each year on the loss amount. This would help to give a more forward looking dimension to the LC and also smooth the "cliff" effect that the current SMA produces when the large losses fall out of the 10 years slot.

  - Very large loss events "extreme losses" (i.e. outlier events) are managed in a specific way at institution and regulators levels (massive remediation plans, pillar 2…). They should not be treated as any other loss, but **should rather either (i) be capped for LC calculation purpose at a certain % (**let's say 500 basis points of BI or CET1[4]), **or alternatively (ii) be excluded from the LC calculation.**

[4] In the last EBA stress test exercise, material events were defined at 10 bp of the CET1. This approach appears relevant even if this level is too low for an outlier event. This is why we suggest to raise the level to 500 bp.

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?

We welcome the fact that the Basel Committee, by leaving the door open for an alternative, is implicitly considering the SMA to be unfinished and flawed. That is the reason why, before considering any alternative proposal whose impact is highly correlated to the unknown m-parameter, we would rather support a deep enhancement of the SMA in line with our different previous proposals.