January 6, 2015

Comments on the Basel Committee on Banking Supervision's Consultative Document
"*Operational risk –Revisions to the simpler approaches*"

Japanese Bankers Association

We, the Japanese Bankers Association, would like to express our gratitude for this opportunity to comment on the consultative document "*Operational risk –Revisions to the simpler approaches*" released by the Basel Committee on Banking Supervision (the "BCBS").

We hope that our comments below will be of assistance and offer an additional point of reference as you work towards finalising the rules.

[General Comment]

The Consultative Document proposes the framework including the development of proxy indicators, with a view to pursuing the objectives "simplicity", "comparability" and "risk sensitivity", in particular "simplicity". We understand the BCBS's intention to explore the proposed direction. There are however some areas that should be reviewed and revised.

Specifically, the Consultative Document states its position that for "large and complex banks", it is sufficient only to take into account their size. We do not support this position because, while the concepts of simplicity and comparability are met, this lacks balance in terms of "risk sensitivity". Operational risk exposure should be different depending on the type of business model, hence we strongly oppose to the point where this issue is not considered.

In view of these, the proposed basic framework, including the adoption of proxy indicators, should take into account "complexity" and "business model" in addition to "size".

We understand the objective of setting a floor in calculating operational risk capital charge for banks which use Advanced Measurement Approaches (AMA), based on capital requirements under the standardised approach. However, dispersion in the outcome of calculation and other issues should be addressed by, for example, ensuring consistency across the approaches, such as consistency of correlation between the measurement units. AMA is the only approach that ensures the compliance with Principle 6 under the Principles for the Sound Management of Operational Risk by BCBS. Additionally, capital charges calculated using this approach will be reflected in regulatory capital, which would incentivise banks to undertake efforts to enhance internal controls and measures to prevent loss occurrence.

Consequently, we strongly oppose to the implementation of a floor based on capital requirement calculated using the revised SA ("RSA") which does not take into account risk sensitivity of financial institutions nor reflects the complexity of a business model since setting a floor using the approach with such nature would contradict with the above principles and disincentivise banks to continuously adopt AMA.

The following Specific Comments section provides our responses to each question in the Consultative Document as well as our specific requests and matters to confirm.

[Specific Comments]

<<1: Our responses to questions>>

Question 1:
Are there any other weaknesses in the existing set of simple approaches that should be addressed by the Committee?

(Our response)

We have not identified any weakness other than those specified in the Consultative Document.

Question 2:
Does a single standardised approach strike an appropriate balance across the Committee's objectives of simplicity, comparability and risk sensitivity?

(Our response)

The proposed single standardised approach is not considered to be sufficient from a risk sensitivity perspective.

(Reason)

In general, implementation of a single standardised approach generally meets the BCBS's objectives of simplicity and comparability.

The proposed approach however is not considered sufficient for the following reasons: This Consultative Document focuses on "large and complex banks" (page 1), and considers these banks to be more exposed to operational risk. The BCBS's size-based approach meets the objectives of simplicity and comparability, but lacks balance in terms of risk sensitivity.

In cases of commercial banks whose core business is a traditional banking business, an increase in interest income on deposits and loans does not necessarily lead to a non-linear increase in operational risk, and hence operational risk should be treated in a different manner depending on the type of business model. We strongly suggest BCBS to take into account these factors in determining the approaches for the measurement of operational risk.

We agree with the proposed basic framework, including the adopting of proxy indicators which prioritise "simplicity", but propose to include "complexity" and "business model" as additional factors to the "size".

For example, it is requested to consider using a different coefficient table depending on the type of business model, or consider imposing higher operational risk charge only to specific businesses such as trading and specific fee-based businesses and business with high volatility in the risk amount. Candidate indicators for determining “complexity” would include “derivatives” and “size of trading account” noted above and “the volume of specific fee-based businesses”.

Furthermore, we strongly oppose to setting a cap in calculating business indicators (BI) for banks with high net interest margin or that are highly specialised in fee businesses, or a floor for banks with low net interest margin or that are not specialized in fee business because setting such cap/floor would contradict with the objective of implementing a simplified framework, and is not appropriate from a perspective of risk sensitivity since losses arising from low-margin transactions are limited as compared to high-margin transactions.

Question 3:
Are there any further improvements to the BI that should be considered by the Committee?

(Response)

We consider that the following improvements should be made to the BI.

(Proposed improvements)

“Other operating expense” includes operational risk losses such as fines, settlement and other similar items which are considered to be increase factors for operational risk requirements under the Consultative Document, however, these items are recognized in the accounts together with other expenses and losses. Therefore, operational losses could be reflected in risk profile by excluding “Other operating expense” from BI item and recognizing a separate BI for operational risk losses which are considered to be increase factors for operational risk requirements, such as fines, settlement and other similar items exceeding certain amount.

Additionally, determination of BI should not excessively rely on accounting treatment and accounts. In principle, one indicator should be used for one accounting event. For example, income and expenses arising from a subsidiary operating a lease or installment sales business are separated into “Other operating income” and “Other operating expense” and reflected in the BI on a gross basis. On the other hand, income and expenses associated with the core business of a bank or securities firms (investments and fund raising and investment in and write-off of government bonds by banks) are reflected on a net basis. This treatment results in a significant difference in the BI depending on the nature of the group’s business. In order to avoid this, Other operating income and Other operating expense should be reflected on a net basis. If this is considered to be impracticable, national authorities should be granted a certain discretion in calculating the BI in the light of local accounting standards and business practices.

Inclusion of absolute value of the banking book (net P&L on the banking book) in the Financial Component is not considered to appropriately reflect operational risk. This is because securities held in the banking book for purposes of long-term investments are not frequently traded, and the size of operational risk is not directly affected by the amount of gains and losses from sales. While, gains and losses from sales of securities held in the trading book which is expected to be frequently traded are considered reasonable to include in the scope by considering risk profile of respective transactions.

Question 4:
What additional work should the Committee perform to assess the appropriateness of operational risk capital levels?

(Response)

There is a significant difference between the level of operational risk capital calculated using the AMA model which reflects the group's risk profile and that calculated under the Operational Risk Capital at Risk (OpCaR) model and the RSA. To eliminate such difference, it is requested to change the coefficient used for the RSA to an appropriate value.

Question 5:
Are there any other considerations that should be taken into account when establishing the size-based buckets and coefficients? How many BI buckets would be practical for implementation while adequately capturing differences in operational risk profiles?

(Response)

There is no other consideration that should be taken into account. The proposed number of buckets is considered to be appropriate.

Question 6:
Are there any other considerations that should be taken into account when replacing business lines with size-based buckets?

(Response)

There is no other consideration that should be taken into account.

Question 7:
Could there be any implementation challenges in the proposed layered approach?

(Response)

There is no implementation challenge.

Question 8:
Do the issues of high interest margin and highly fee specialised businesses in some jurisdictions need special attention by the Committee? What could be other approaches to addressing these issues?

(Response)

There is no special attention to be paid by the BCBS. We do not support setting a cap or floor in calculating the BI.

(Reason)

The two approaches proposed for consideration in this Consultative Document, which are “to impose operational risk capital requirements that commensurate with the business size of a bank” and “to set a cap on the BI calculated for high interest margin and highly fee specialised businesses”, are conflicting approaches. If the former is adopted and the BI is based on the profit which is one of indicators representing the size of business, capital charge for both high interest and low interest margin transactions should also commensurate with the profit amount, and setting a floor and cap is not considered necessary.

On the other hand, with regard to net profit (loss) on financial operations for the banking and trading books that are considered in calculating the “Financial” component, no floor is set even in the cases of small trading gains. To ensure consistency across components, setting a floor for low interest margin and low fee specialized business should not be required for any businesses.

Question 9:
What would be the most effective approach to promoting rigorous operational risk management at banks, particularly large banks?

(Response)

AMA is considered to be the most effective approach. Qualitative standards to be applied should be unified into the Principles for the Sound Management of Operational Risk by BCBS.

(Reason)

The most effective approach to promote rigorous operational risk management is the AMA approach, which closely relates the measurement of operational risk with a day-to-day operational risk management.

Annex4 sets forth the qualitative standards regarding operational risk management. Under these standards, the BCBS requires individual banks to comply with the Principles for the Sound Management of Operational Risk. To avoid duplicated management burden arising from imposing double standards, qualitative standards to be applied should be unified into the Principles for the Sound Management of Operational Risk.

<<2. Other requests and matters to confirm>>

<Other requests>

[Backgrounds of revision]

Backgrounds of revisions to the operational risk standardised approaches are to address gaps between specific loss events occurred at individual banks and capital requirements for operational risk. Please provide in more details what loss events have occurred and how gaps have occurred.

[Operational risk loss data collection] (Annex 4)

We would like to confirm that “large internationally active banks” specified in this standards refer to G-SIFIs.

[Implementation timing]

Currently, it is expected that there are some items that may be difficult, or take considerable time, to extract based on new accounts proposed in the Consultative Document. It is therefore requested to set sufficient lead time to establish processes and procedures for extracting data and to assess that each component comprising the BI can be calculated accurately and timely in accordance with new requirements.

[Setting a floor for calculation of capital requirements under AMA]

AMA is a measurement approach which directly reflects in the calculation of capital requirements external loss data, risk scenarios, business environments and internal control factors in addition to internal loss data. This is the only approach that ensures the compliance with Principle 6 under the Principles for the Sound Management of Operational Risk. This principle sets forth that the bank should have policies, processes and procedures to control and mitigate significant operational risk, and that the bank should periodically review its strategy to limit and control risks, and adjust its operational risk profile based on a strategy considered appropriate in the light of the bank’s overall risk appetite and risk profile in response to such revised strategy. Additionally, capital charges calculated using this approach will be reflected in regulatory capital, which would incentivise banks to undertake efforts to enhance internal controls and measures to prevent loss occurrence.

We understand the objective of setting a floor in calculating operational risk capital charge for banks which use the AMA, based on capital requirements under the standardised approach. However, dispersion in the outcome of calculation and other issues should be addressed by, for example, ensuring consistency across the approaches, such as consistency of correlation between the measurement units. We strongly oppose to the implementation of a floor based on capital requirement calculated using the RSA which does not take into account risk sensitivity of financial institutions nor reflects the complexity of a business model since setting a floor using the approach with such nature would contradict with the above principles.

[Calculation methodology using the RSA]

In calculating operational risk capital requirements using the RSA, the BI should first be calculated using financial data for each individual company, and aggregates RSA capital requirement for each company computed using coefficients that correspond to the related BI item.

For purposes of calculation using the NSA, it is requested to allow deducting inter-group transactions.

<Matters to confirm>

[Calculation methodology for the BI] (Paragraph 13)

We would like to confirm whether income statement items are only used for BI calculation purposes.

[Calculation of “Service” component] (paragraph 20, Annex 1)

We would like to confirm that provisions recognized for fines, penalties and litigation settlements are not included in “Other operating expenses” in the “Service” component.