

June 3, 2016

Comment on the Consultative Document: *Standardised Measurement Approach for operational risk*, issued by the Basel Committee on Banking Supervision

Japanese Bankers Association

We, the Japanese Bankers Association (“JBA”), would like to express our gratitude for this opportunity to comment on the second consultative document: *Standardised Measurement Approach for operational risk*, issued by the Basel Committee on Banking Supervision (“BCBS”).

We respectfully expect that the following comments will contribute to your further discussion on finalising the rules.

[General Comments]

We appreciate that the new standardised measurement approach (SMA) has greater risk sensitivity compared to the approach proposed in the first consultative document. The proposed framework takes into account differences in the “business model” and “complexity” across banks, although indirectly, in addition to the bank’s “size”, by incorporating the bank’s historical internal loss into the Loss Component. However, for the better balance between risk sensitivity, simplicity and comparability, further revisions towards risk sensitivity are necessary as well as consideration to reduce volatility in capital outcomes.

A due consideration is warranted for the implementation of SMA, to avoid a significant increase in the capital requirement, as already indicated by the BCBS. The impact at an individual bank level, as well as the industry level, should be carefully assessed. In particular, we respectfully request the BCBS to review the multiplier for each bucket of the Business Indicator (BI) and that for each loss event of the Loss Component by fully factoring in the quantitative impact study (QIS) data and the results of qualitative analyses provided by the industry.

Still, operational risk differs significantly across the business models and therefore standardisation has its limitation. To capture such divergence, it is important to revise Pillar 1 (Minimum Capital Requirements) together with Pillar 2 (Supervisory Review Process) and Pillar 3 (Disclosures and Market Discipline). In particular, in order to appropriately capture jurisdictional characteristics arising from differences in local laws and regulations, a framework for capital add-ons to individual banks under Pillar 2 should be considered, rather than increasing the capital significantly across the board under Pillar 1.

We strongly oppose the withdrawal of the Advanced Measurement Approach (AMA) introduced in Basel II. AMA allows banks to reflect broader potential risks with the combined

use of internal loss data, scenario analysis, forward looking information including business environment and internal control factors. Incorporating risk measurement under the AMA into regulatory capital has been an incentive for banks to enhance their internal controls and loss prevention<sup>1</sup>. Such a framework should be retained.

Complexity and lack of comparability which are indicated as reasons for the withdrawal of the AMA can be addressed by, for example, the standardisation of models and enhanced disclosures. In addition, certain variability in the AMA outcomes reflects differences in risk profile across banks and hence should be accepted.

Against this backdrop, as an alternative to the AMA, we propose a hybrid approach that identifies areas of operational risks that are amenable to modelling and those that are not, and then measures each area accordingly. For example, low-impact and high-frequency events such as operational errors are highly amenable to modelling, while high-impact and low-frequency events such as huge legal cost, fines and massive earthquakes. For the latter, we consider it reasonable to calculate capital requirement under the SMA using the BI since these are not amenable to modelling. However, applying the SMA to events that can be modelled is not reasonable. Detailed discussions on the AMA are provided in Appendix.

The Specific Comments section provides our responses to each question provided in the consultative document, and our additional requests and matters for confirmation.

[Specific Comments]

<<1. Our responses to the questions>>

Question 1. What are respondents' views on the revised structure and definition of the BI?
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(Our response)

We welcome the revised definition of BI in that improvements are made compared to the first consultative document; for example, the treatment of the income and expenses from financial and operating lease has been revised. However, there are still some areas for improvement.

[Treatment of internal losses for the BI]

As noted in this consultative document, the BI reflects the size of the business, while the Loss Component reflects the quality of operational risk management. However, internal losses are not dependent on the business size, but on the quality of operational risk management. Therefore, for the SMA, internal losses including provisions/reserves related to operational risk should be excluded from “Other Operating Expenses” of BI.

Provisions/reserves are used when a loss actually occurs in the future, and

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<sup>1</sup> AMA is the only measurement approach that can ensure the implementation of the Principle 6 of the Principles for the Sound Management of Operational Risk established by the BCBS.

provisions/reserves by nature do not constitute internal losses. Also, as described in the consultative document, the methodology for provisioning is different across banks or jurisdictions, and therefore it is difficult to establish a uniform standard on a global basis. If this were to be treated as an internal loss, comparability may rather decrease<sup>2</sup>. Further, in practice, provisions/reserves are often recognised based on the conservative estimation, and in most cases, larger than the actual losses. Consequently, treating these as an internal loss could prevent prudent and appropriate provisioning.

If the BI were to include provisions/reserves as internal losses, the amount of provisions/reserves to be recognised should be limited to those that cover average losses from businesses. For cases that are already provisioned and result in the actual losses, both provisions and actual losses from the same case will be recognised in the BI, which is double-counting with no reasonable grounds. In view of this, losses that are already provisioned should not be included in internal loss data.

#### [Multiplier for the BI]

The BI reflects the size of the business and hence is not an indicator of the complexity of business model and the risk profile reflecting business environment and internal control factors. Essentially, the risk sensitivity should be enhanced with the Loss Component which reflects the complexity of business model and differences in risk profiles. Assuming that the risk increases in tandem with the size of the business is not reasonable. Therefore, the multiplier for each bucket of the BI should be the same irrespective of the size of the business.

#### [Methodology for the Financial Component]

Purchase or sale of securities in the banking book for long-term investment purposes are not executed frequently and its P&L has no direct link to the operational risk. Therefore, such P&L (Absolute Value (Net P&L on the banking book)) should not be included in the “Financial component”. On the other hand, it is reasonable to include P&L from purchase or sale of securities in the trading book in the BI.

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?

(Our response)

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<sup>2</sup> Note 12: For instance, in some countries, the impact of some events (eg legal events, damage to physical assets) may be known and clearly identifiable before these events are recognised through the establishment of a reserve. Moreover, the way this reserve is established (eg the date of discovery) can vary across banks or countries.

We are of a view that the proposed revision is appropriate since the inclusion of loss data into the SMA calculation will provide incentives for banks to enhance their operational risk management. The internal loss data reflects the business model and risk profile such as business environment and internal control factors. However, we propose following in order to further enhance the risk sensitivity.

[Scope of SMA loss data set]

The use of internal loss data allows to indirectly reflect the business model and risk profiles such as business environment and internal control factors. However, internal losses will be double counted for the purposes of calculating the capital adequacy ratio, because capital will be eroded when losses occur, and at the same time internal losses will be taken into account in the calculation of capital requirements. Thus, internal losses used for the SMA should be limited to those that enable appropriate capturing of current or prospective risk profile; for example, losses that are likely to occur over the future period.

If the SMA loss data set would not be limited to above-mentioned losses, internal losses that are not likely to occur in the future should be excluded from the SMA loss data set. Examples of such internal losses may include those that meet the following conditions:

- Internal losses which had occurred from a business which is not currently operating due to, for example, changes in laws and regulations;
- Internal losses arising from the business that is already sold or discontinued; or
- Internal losses which can be ensured that such losses would not occur any more since risk mitigation actions have been completed.

The use of historical 10-year internal loss data for SMA purposes is not appropriate for capturing current and future risk profile of individual bank since the business environment surrounding each bank and the quality of operational risk management significantly change over time. Therefore, the observation period should be reduced (for example, to 5 years). On the other hand, the shortening of the observation period may considerably increase capital charge when a high-impact low-frequency loss occurs, which may give rise to a concern on the capital stability. To address this, the multiplier for loss events above €100 million (currently set at 5) in the Loss Component should be reduced so as to avoid impairing capital stability.

If a 10-year observation period were to be used for the internal loss data, the transitional arrangement to temporarily allow a 5-year observation period should be permitted for AMA/TSA banks. The definition of internal loss described in this consultative document is not necessarily consistent with the current standards adopted by individual banks (for example, the use of gross loss and the addition of indirect losses). Therefore, AMA/TSA banks do not necessarily retain 10 years of the internal loss data that meet the definition set out in this consultative document, and hence these banks need to collect additional data. In view of this,

when initially introducing the proposed framework, AMA/TSA banks should also be allowed to use the 5-year period data for internal loss data under the revised standards. In addition, G-SIBs include both AMA/TSA banks and BIA banks, and not allowing the transitional arrangement only for AMA/TSA banks would be lack of level playing field.

[Threshold of the internal loss data used for the Loss Component]

The thresholds for the loss events in the Loss Component (€10 million and €100 million) should be raised to €100 million and €1 billion, respectively, so as to appropriately capture huge operational risk loss events, with a view of enhancing the effectiveness of SMA and further increasing risk sensitivity. For the same reason, the de-minimis gross loss threshold should be raised from €10,000 to €20,000. As discussed above, if the de-minimis gross loss threshold were to be set at €10,000, not all AMA/TSA banks have the data set that meets the definition under this consultative document, and hence the transitional arrangement should also be permitted for AMA/TSA banks.

[Treatment of provisions/reserves]

Provisions/reserves related to operational risk should be excluded from operational risk losses since provisions/reserves, essentially, are not internal losses, as discussed above. Also, differences in local accounting standards for the recognition of provisions/reserves and possibility of undermining sound provisioning practice should be take into account.

If provisions/reserves were to be included in the Loss Component as the internal loss data, the scope should be limited to the provision whose related losses are set to materialise in the following period, such as fines. And losses actually occurred should be excluded from internal losses. Alternatively, individual banks should be permitted to establish appropriate standards for the timing of loss recognition; i.e., whether losses should be recognised when an actual loss has occurred, or when a provision is recognised.

<p>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?</p>
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(Our response)

We oppose the introduction of an alternative method since such a method would prevent the enhancement to risk sensitivity which is the objective set out in this consultative document.

In order to enhance risk sensitivity, the impact of the internal loss data on the capital requirement needs to be further increased. However, since the alternative method is designed in a manner to limit an increase in capital requirement for banks with huge amounts of historical internal losses, such a method would be less risk sensitive and provide less

incentives for banks to limit losses through an appropriate operational risk management. In addition, a situation where the introduction of such method increases capital requirement for banks with low internal loss data should be avoided.

We understand that the Internal Loss Multiplier is intended to reflect to capital requirements the size of historical loss experiences relative to the size of business. In this regard, under the alternative method, both historical internal losses and the size of business are included in the numerator and denominator, which make it difficult to understand the meaning of this multiplier.

## <<2. Other requests and matters for confirmation>>

### <Requests>

#### [Indirect losses]

Not many banks have been collecting data on indirect losses<sup>3</sup> referred in this consultative document. Since the definition of indirect losses may differ by jurisdictions and banks, indirect losses should be excluded from the SMA loss data set in order to ensure simplicity and comparability.

#### [Timing loss]

Material “timing losses” should be limited to those that may result in material misstatement of financial statements (for example, losses exceeding €10 million or €100 million) since, over time, there is no net impact arising from such timing losses.

#### [Definition of gross losses]

“Gross losses net of the amount collected” should be used, since the SMA internal loss data should reflect internal control factors such as a bank’s proactive collection efforts. Examples of collection may include collection of erroneous remittance and a difference in the amount from remittees and collection from insurance companies, outsourcees and others responsible for the incident. For erroneous remittance, the same treatment should be applied to both double remittance and third-party remittance. Losses promptly collected should be excluded from the internal loss data. Because, if erroneous inter-bank remittance or differences in the amount is immediately corrected, such an event is not treated as a loss in practice, and the impact of such an event is limited.

#### [Implementation timing]

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<sup>3</sup> 6.2 (b) Costs incurred as a consequence of the event including external expenses with a direct link to the operational risk event (eg legal expenses directly related to the event and fees paid to advisors, attorneys or suppliers) and costs of repair or replacement, incurred to restore the position that was prevailing before the operational risk event;

At this stage, it is expected for banks to take considerable time in developing a framework to collect data on new accounts and internal loss data in accordance with the proposal. Therefore, with respect to implementation timing, the BCBS is requested to establish sufficient lead time so that banks can make sure that the calculation is accurate and timely.

[Scope of consolidation]

If a bank has a number of subsidiaries at a consolidated level, it is impracticable to require all of its subsidiaries to satisfy the requirement to collect loss data. It is also necessary to clarify the treatment of the BI and the Loss Component in case of the acquisition/sale of an entity or a business and discontinuity of a business. For example, it is impracticable to retrospectively collect data related to any losses occurred before the consolidation of subsidiaries, and use such data to calculate capital requirements. For those cases, phase-in application and the appropriate scope of internal loss data collection based on the materiality should be necessary.

<Matters for confirmation>

[Frequency of measurement]

Please confirm that the frequency of measurement is once a year taking into account that the annual average is used for BI and internal loss data.

[Definition of provisions]

Please confirm that provisions included in operational risk losses refer to the amount of provision recognised in the P&L and not the balance of reserves on the balance sheet.

[Appendix]

Operational risk capital requirements calculated using the AMA is equivalent to the maximum amount of operational risk losses estimated using 99 percent confidence interval and the 10-day holding period. It takes into account the following four elements: internal and relevant external loss data, scenario analysis, bank-specific business environment and internal control factors.

The AMA is capable of reflecting broader potential risks to operational risk capital requirements because it identifies significant operational risk which banks may experience in the future based on the combined use of these four elements, not merely internal loss data, and input in the risk measurement model data that incorporates estimated frequency of occurrence and loss amount. This approach would provide incentives for banks to enhance their internal controls over potential risks, thereby strengthening the banks' capability of operational risk management, since, under this approach, operational risk capital requirements would increase

as potential risks increase, even though risks may not be materialised as a loss.

Further, the AMA timely takes into account most recent changes in business environment and internal controls, such as changes in the amount of transactions, the revisions to laws, the introduction of IT system and the revisions to procedures. Hence, the resultant change in capital requirements fits well with management and business units.

The adequacy of capital requirement can be constantly ensured through periodic verification of the adequacy of risk measurement model and autonomous review of the model by banks.

AMA banks to date have evolved their operational risk management activities by leveraging the usefulness of the AMA described above. If the AMA is withdrawn, business units of banks would take this as disapproval of their efforts to establish an operational risk management framework that seeks to reduce risk capital charge by enhancing internal controls. This may give rise to a concern that the control function which the risk management department has over the business units may be weakened due to, for example, diminishing of consciousness to prevent potential risks from being materialised; and that the stability of banking system may be undermined since investments to prevent the occurrence of operational risk events will be reduced, thereby reducing the bank's risk management capability and resulting in massive loss events.

It is premature to discuss the withdrawal of the AMA with a short sighted view, merely focusing on some issues with it. In order to avoid losing fruitful achievement the AMA has gained to date, the issues of the AMA should be addressed by making necessary adjustments, while respecting the advantages of AMA. The SMA should be viewed as a complementary method where the AMA cannot be applied.

On the other hand, in order to enhance comparability, the variability of capital outcome across banks caused by the AMA needs to be reduced. The AMA is a framework with a high degree of latitude that enables to appropriately reflect differences in risk profile of individual banks. However, it is necessary to narrow such the AMA's latitude to some extent so as to reduce excessive variability which cannot be explained by differences in risk profile. Specifically, following initiatives are proposed.

Convergence of risk measurement model is worth consideration; for example the use of common measurement units, standardisation of methods for determining the distributions of amounts and frequency for scenario analysis purposes, standardisation of approaches for using external loss data. In particular, with respect to the correlation between measurement units, the concept and treatment differ considerably across banks, and therefore, it is preferable to introduce common guidance including the elimination of correlation.

The AMA covers broad areas of measurement, ranging from the areas where risk profile can be captured appropriately through the internal loss data to areas where risk profile cannot be captured through internal loss data only, such as massive natural disasters and



finances/penalties imposed by authorities.

The hybrid approach that applies the authority or industry-led standardised model to the latter and the internal loss data based measurement to the former which can be well managed with the incentives for banks to enhance their internal controls is a promising option that strikes the balance between maintaining the benefits of the AMA and increasing comparability.

Excessive variability can be reduced by undertaking an initiative to review relative conservativeness across AMA banks, such as an AMA benchmarking exercise conducted by the BCBS in 2014. In addition, it is worth considering a program to introduce a measure that serves as a benchmark for operational risk capital requirements (e.g., a better measurement model that builds on the OpCaR established by the BCBS) and periodically review differences against the benchmark.

The enhancement of disclosure by each bank on the nature of the risk measurement model with the result of model validation, and the internal stress testing methodology with its results, would serve as a significant foothold for enhancing comparability.

Various practices also exist for supervisory review and approval requirements. Standardisation and strengthening of supervisory review and approval requirements could enhance the comparability.

As discussed above, various issues related to the AMA could be solved. We strongly believe that the best approach for better operational risk management is to improve the framework of the AMA.