3 June 2016

EBF Final Response to the BCBS Consultative Document on the Standardised Measurement Approach for operational risk

The European Banking Federation (EBF) welcomes the opportunity to comment on this second consultative document in which the Basel Committee for Banking Supervision (BCBS) puts forward policy proposals to replace the current approaches for operational risk (Basic Indicator-BIA, Standardised-SA and Advanced Measurement-AMA) with a single non-model-based method, the Standardised Measurement Approach (SMA).

The SMA relies on the simplicity and comparability provided by a standardised approach, proposing the risk sensitivity through the banks' internal loss experience, which was a contributory component of the AMA. Therefore, this new proposal of 4 March 2016, maintains the introduction of a Business Indicator (BI) as a new proxy for operational risk exposure (with some modifications regarding the definition from the October 2014 proposal) and incorporates the Loss Component which depicts past risk experience, considered to add some risk sensitivity.

In this document, the EBF presents its observations on the Basel Committee's review of the operational risk (OR) measurement framework.

EBF key points:

- The EBF shares the Basel Committee's goal of increasing simplicity and comparability of risk weighted assets among institutions. Given the existing differences across jurisdictions regarding business mix or operational risk management standards, we are concerned that a "one-size-fits-all" solution will not properly capture these differences.

- The European banking industry acknowledges the importance of having an active management of their bank's operational risk through risk sensitivity, based mainly, on control and governance, policies and processes embedded in their organisations. Important investments have been made to put in place thorough risk measurement and management.

- Aiming at having a complete framework for operational risk, the EBF considers that beyond the Business Indicator (mainly size of the institution) and the past risk experience, the Basel Committee should take into consideration and encourage strong and effective risk management measures.

- Although the Basel Committee's objective with this proposal is not to significantly increase overall capital requirements (as stated in the proposal), the SMA will result in higher capital requirements for nearly all banks[1] even for those with good profit margins and low loss records:
    - 75% of banks would see an increase in capital;
    - median capital increase of 33%;
    - mean capital increase of 61%;
    - quarter of banks would see an increase of 70% or more.

  European banks will see the biggest increase under the SMA (79.6% mean and 63.5% median) in comparison with the current regulatory approved capital.

- In addition, there are other pieces of regulation that are still being revised or implemented at the same time, e.g. leverage ratio, BRRD... Therefore, the combined effect of all of them for each bank must be carefully considered. Based on the fact that Basel Committee has used for its calibration the results of a previous QIS exercise, we would like to highlight that this data was not including all relevant losses from Conduct events in the global banks (data was preliminary at this point in time and provisions were not already allocated). This factor results in an underestimation of the total impact of the SMA for the industry. For these reasons the EBF considers it relevant to carefully look at the results of the next QIS for recalibration and to take into consideration the structural differences by jurisdictions.

- At this point of regulatory reform, banks at large have recapitalised in response to the financial crisis and the European financial industry has substantially increased its capital buffers. The rationale for additional capital requirements should be carefully scrutinized to prevent side effects. It is well recognised that unnecessary capital requirements will lead to credit shrinkages, less productive investment in the real economy and a shift of risk to unregulated activities.

- Therefore, the EBF strongly recommends a recalibration of the current proposal as the SMA is not capital neutral in comparison to the current regulatory approved capital requirements and therefore it is not aligned with the Basel objective to not increase capital significantly. There is clearly an overlap of the SMA proposal with the implementation of Basel III capital adequacy buffers for systemic institutions which should be taken into account.

- The EBF considers that the extreme loss events are excessively penalising and requests the modification of the Loss Component formula. The EBF proposes:
    - i)   a continuous bucket structure;
    - ii)   the recalibration of the coefficient factors applied;
    - iii)   the introduction of a discount factor applied to the historical loss events;
    - iv)   the elimination of losses arising from divested or discontinued business or product lines;
    - v)   the elimination of the large loss events outliers or the introduction of a cap for large losses in the Internal Loss Multiplier calculation; and
    - vi)   the incorporation of a forward looking component to improve the risk sensitivity of current proposal.

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1 According to the ORX (Operational Riskdata Exchange) benchmark exercise carried out in March 2016 with a sample of 54 banks from Australia, Canada, Europe, South Africa and USA.

Specific BCBS questions

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

The EBF supports certain improvements set by the BCBS in the BI Component in the present consultation. These eliminate some distortions visible in the last consultation document published in October 2014, namely: i) inconsistent treatment of dividend income, ii) overcapitalisation of banks with high net interest margin, and iii) the inconsistent treatment of leasing compared to credit.

Nonetheless, the EBF highlights the following specific comments in relation to the revised structure and definition of the BI:

- **Calibration and calculation of the BI:**
  Theoretical and empirical justification of the new method is not disclosed, to understand how scaling coefficients of LC and scaling factors used in the BI formula are supported. Therefore, the EBF would appreciate more transparency and details on the calibration methodology of all components included in the proposal. The information on SMA calibration is essential to better understand the risk sensitivity of the proposed methodology, as well as to challenge the structure and definition of the SMA.

- **Size-based Business Indicator**
  The proposed Business indicator (BI) component is size-based and does not take into consideration the wide diversity of business models, which do not represent the same operational risk profile.

  It is difficult to identify how the revised structure and definition of the BI, or the BI approach in general, addresses the fact that the OR profile of a bank measured via the SMA can increase even without activity growth, such as occurred during the recession of 2008 or as may arise from cybercrime. The OR profile is in fact more sensitive to the effectiveness of the operational risk framework and associated control processes than the size of the business.

  Size primarily dictates SMA capital, but simulations show that the SMA can be volatile when introducing atypical operational risk events such as large regulatory fines or settlements. The impact of large loss events can vary substantially between institutions.

- **Exclusion of OR losses from the Other Operating Expenses (OOE) in the BI calculation:**
  The Operational Risk losses/provisions should be excluded from the OOE to avoid double impact when the same losses/provisions are included in the Loss Component.

- **OR provisions should be deducted from the BI Component:**
  While the provisions cover Expected Losses, capital requirements should cover the Non-Expected ones. The application of an ex-post deduction of the total amount of provision, representing expected losses, could lead to a better representation of the risk exposure since capital should cover the unexpected losses. Otherwise a double counting of OR costs applies.

- **Services Component:**
  The EBF proposes to simplify the formula set for the Services Component. We propose to incorporate a simple netting of income and expenses, or at least to remove the cap specifically introduced for banks with share of fees greater than 50% of unadjusted BI. Retaining this cap would provide incentives for banks to mainly concentrate on activities generating fees.

- **Accounting standards should be taken into account:**
  To ensure a level playing field, the differences in accounting standards -notably between US GAAP and IFRS- should be taken into consideration, as both the BI and Loss Component calculations are based on accounting figures and records.

- **"Normalized" balance-sheet – clarification would be welcome:**
  Basel should indicate whether banks should refer to the "Normalised" balance-sheet or to the standard balance-sheet for the Business Indicator calculation (eg. situations as mergers, disposal of business situations during the year…). The industry needs guidance in how to calculate the proposed SMA components when a new bank is acquired in a business combination or sold.

  Some P&L items could include extraordinary income and extraordinary expenses arising from business disposals and/or other organizational interventions aiming at reducing the bank's risk profile (e.g. Net Profit/Loss on financial Operations -Trading and Banking Book-, Other Operating Income, Other Operating Expenses, etc). This condition would lead to an increase of the regulatory capital, which could be a disincentive and produce an incoherent effect with respect to the risk profile trend. Moreover, no instructions are provided for the treatment of extraordinary and/or irregular items.

  Since the Business Indicator and Loss Component are defined using annual averages and the reporting is done more frequently than only on an annual basis, the methodology for calculating the average should be articulated.

- **The use of Euro parameters introduces unacceptable FX risk:**
  All measures and formulas in the proposal are expressed in Euro currency which will introduce an FX risk in the SMA calculation for jurisdictions with different functional/reporting currencies. This could be an issue for non-Eurozone banks as well as for Eurozone banks with subsidiaries in third countries.

  The FX volatility could increase the size of a bank's BI bucket without changes in its operational risk profile, which will result in unwarranted higher capital charges.

  The EBF proposes that calculations are set in local currency, based on the fact that regulator has discretion to set the currency equivalent of the standardised euro values.

> **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?**

The EBF supports the Committee's objectives of comparability, simplicity and harmonisation introduced with the new Standardised Measurement Approach for operational risk, trying to reduce variability in risk-weighted asset calculations and promoting a level playing field.

However, the following key points should be taken into consideration:

a) **Impact assessment:**
"*For most banks, the Committee expects that these proposals will have a relatively neutral impact on capital. While the objective of these proposals is not to significantly increase overall capital requirements, it is inevitable that minimum capital requirements will increase for some banks*," said Mr. Ingves, announcing the consultation.

As already mentioned in the introductory notes, the SMA is not capital neutral in comparison to current regulatory approved capital - 75% of banks would see an increase in capital; the median is a capital increase of 33%, the mean change an increase of 61%, and quarter of banks would see an increase of 70% or more.

It should be highlighted as well, that the disproportionately high capital impact that this new proposal may have on AMA-compliant European banks is an area of great concern.
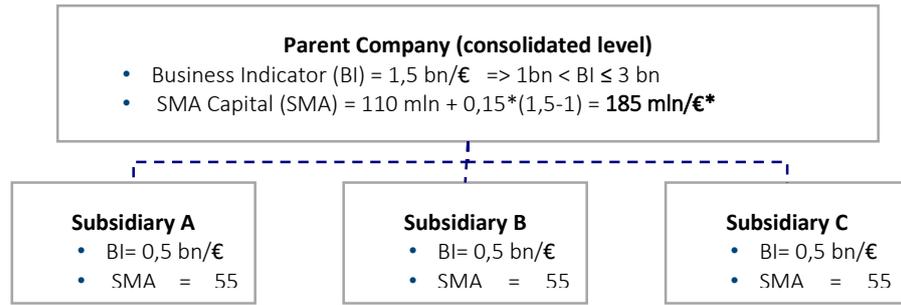
Based on this, the EBF requests a recalibration of the global impact based on the new QIS exercise before any further steps are taken.

b) **Compounding the overall impact:**
The proposed SMA metric incorporates an exponential aspect for large institutions with extreme loss events. We understand this aspect has been incorporated based on the Committee's argument that "capital needs for OR were found to be increasing in a non-linear fashion with a bank's size" as stated in October 2014 proposal. However, the fact that there is clearly an overlap of the SMA proposal with the implementation of Basel III capital adequacy buffers for systemic institutions should be taken into account. A possible solution would be to reduce the D-SIB, G-SIB and counter-cyclical capital buffers with the operational capital requirement equivalent exceeding 15% of the BI in order to avoid duplication of systemic risk requirements.

c) **Super-additivity and scope of the application:**
The calculations at consolidated level significantly exceed the implied SMA resulting from the sum of the SMA capital measures quantified at bank subsidiary level (see an example below).

Parent Company (consolidated level)
- Business Indicator (BI) = 1,5 bn/€ => 1bn < BI ≤ 3 bn
- SMA Capital (SMA) = 110 mln + 0,15*(1,5-1) = **185 mln/€***

Subsidiary A	**Subsidiary B**	**Subsidiary C**
• BI= 0,5 bn/€	• BI= 0,5 bn/€	• BI= 0,5 bn/€
• SMA = 55	• SMA = 55	• SMA = 55

(*)For sake of simplicity it is assumed that the internal Loss Multiplier = 1

This fact may cause capital requirements allocation issues. The extra capital above the subsidiaries calculations may need to be allocated at the holding company level, without clear and cost effective alternatives of transforming this capital into new income-earning credit assets.

The EBF believes that the way legal entities are organized in an institution should not have a key effect on capital requirements.

d) Extreme loss events over-calibrated:

$$\text{Loss Component:} \quad \begin{array}{l} 7 \times \text{Average Total Annual Loss (ATAL)} \\ + \; 7 \times \text{ATAL (only loss events} > €10m) \\ + \; 5 \times \text{ATAL (only loss events} > €100m) \end{array}$$

We consider that the extreme loss events are over-calibrated under the proposed formula set in paragraph 31, both as a result of the factors applied to the loss averages together with the proposed buckets set for the losses (less than €10M / €10-100M and >€100M). The lack of granularity in the Loss Component results in cliff effects and volatility.

It should be reconsidered whether the 7+7+5 coefficients applied to the Average Total Annual Loss (ATAL) parameter is well calibrated. This may result in losses above €100M may having a 19x multiplier at the Loss Component calculation.

The SMA formula does not seem efficient (defining the loss profile by a sum of averages) and no longer distinguishes low intensity/high frequency risk and high intensity/low frequency risk as was possible with the AMA.

The EBF is proposing the following possible solutions to avoid this over-calibration of the Loss Component:

- The review of current coefficients (7+7+5) to avoid over-calibration.
- The introduction of a continuous bucket structure. The EBF considers more suitable if only the amount exceeding the threshold (€10M/€100M) would be part of the size bucket and not the total loss amount.

    This alternative proposes that only the exceeding amount above the thresholds should be multiplied by the relative coefficient:

Loss Component

$$= \begin{aligned} &\alpha_1 \cdot Average\ Total\ Annual\ Loss \\ &+\alpha_2 \cdot Average\ Total\ Annual\ Loss\ only\ including\ loss\ events\ above\ €10\ million \\ &\quad (only\ including\ the\ loss\ amount\ above\ €10\ million) \\ &+\alpha_3 \cdot Average\ Total\ Annual\ Loss\ only\ including\ loss\ events\ above\ €100\ million \\ &\quad (only\ including\ the\ loss\ amount\ above\ €100\ million) \end{aligned}$$

Where α_1, α_2 and α_3 are the coefficients. In the current setting $\alpha_1 = 7, \alpha_2 = 7$ and $\alpha_3 = 5$.

This approach allows to have a loss component less affected by cliff effects. The graph below shows the Loss Component increase as a function of an additional single loss amount for both interpretations:
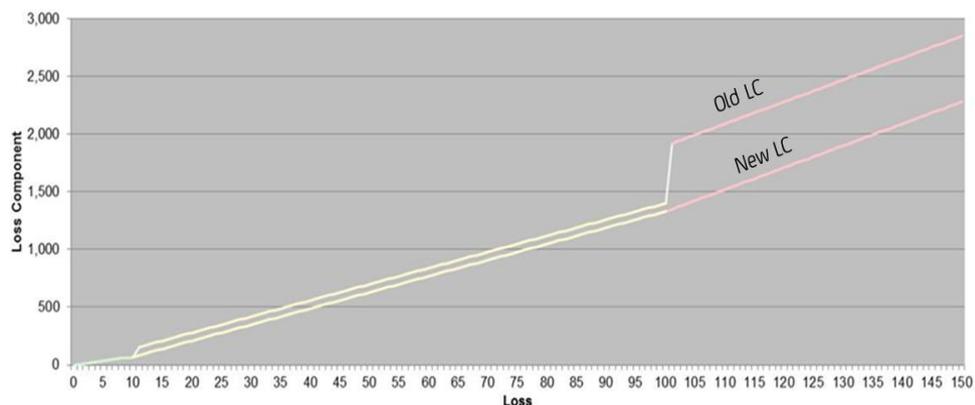
This interpretation of the loss component is also consistent with the business indicator bucketing definition.

- Inclusion of the frequency information in the Loss Component:
  In order to come up with an easily comparable measure, the SMA is calibrated without taking into account the high variability of operational losses in banks' portfolios, since the scattering both between banks and between jurisdictions in terms of loss experience is high. It indeed only apparently creates a level playing field because numbers are computed in the same way.

  The calibration of the Loss Component would be improved by considering also the number of losses. Indeed, the current definition of the loss component takes into account only the amounts of losses, not the number involved leading to some inconsistencies.

e) Volatility and large loss events:

The current proposal for the Loss Component may introduce volatility in the OR capital requirements. Any extreme loss event may cause cliff effects in the SMA calculation, as a result of how the Loss Component has been calibrated.

When new large losses occur and/or when large historic losses drop off after ten years the levels of capital change significantly. This is not generally in line with real movements in the risk profile and is undesirable for capital management purposes. Consistent capital

attribution becomes difficult and risk based pricing models are suspect and hence validation of the business model is called into question.

Volatility can be triggered by very large loss events. However, "extreme losses" (i.e. outlier events) are managed in a specific way at both institution and regulators levels (massive remediation plans, pillar 2...). They should not be treated as any other loss. EBF recommends that large losses should rather either (i) be capped for ILM calculation purpose, or alternatively (ii) be excluded from the ILM calculation.

f) **The SMA has a long memory** (10 years average for the Loss Component calculation).
We understand that the intended objective of using a longer observation period for Internal Loss Data is to minimize volatility in the resulting operational risk capital requirement year on year and to capture a full economic cycle. However, the SMA treats all losses within the previous 10 years as equally relevant to the current risk profile of an institution, which we do not consider appropriate as banks will have changed their processes, product offerings etc.

The EBF proposes:
- The introduction of a decreasing coefficient (i.e. linear discount factor of 10% each year) in relation to the ageing of the loss event. This proposal i) materializes benefits of the remediation actions and ii) would reduce the cliff effect in capital requirement produced when the large losses fall out of the 10 years period. The decreasing factor aims to reflect the improvements in the effectiveness of the internal control framework in response to significant loss events.
- A reduction of the historical observation period from 10 to 7 years, instead adding 3 additional years of projections based on internal and applicable external data and current and expected changes in the business and internal risk and control environment.

The introduction of these projections may allow the introduction of a more current risk sensitive forward-looking element into the SMA calculations. However, it should be optional to avoid exceptionally burden on small & medium size banks for the sake of the respect of the principal of proportionality.

g) SMA Capital requirements formula – Loss component not included for Bucket 1:

The EBF does not agree with the rule to set the Internal Loss Multiplier (ILM) at 1 for banks with BI below €1bn. If a bank satisfies the criteria for loss data identification, collection and treatment (sections 6.1 and 6.2 of the SMA consultation), the bank should be able to adopt the multiplier, regardless of the bank's BI size. In fact, the

Committee acknowledges that there are around 20% of banks with a BI above €1bn which are using the Basic Indicator Approach. As proposed, these banks would be able to use the ILM (if the criteria were fulfilled), but banks that currently use a more sophisticated approach (e.g. TSA or AMA as subsidiaries of large banking groups, which have been AMA compliant for many years) but have a BI below €1bn will not be able to use the ILM.

As such, the current proposal should be adjusted to allow for the use of the ILM by all banks, provided the loss data criteria are met. The fairness of such adjustment would allow banks that have robust internal procedures to use ILM, regardless of the size of their BI value. Additionally, as the former approaches (BIA, TSA and AMA) will be removed, this adjustment would have the benefits of creating incentives for banks that currently use BIA to improve their internal processes to be able to use the ILM.

h) **The SMA risk sensitivity should consider other sources of information**
The EU has taken a considerably broader view of risk than Basel. According to Article 322 of the CRR, (Regulation (EU) No 575/2013) "*an institution's operational risk measurement system shall include the use of internal data, external data, scenario analysis and factors reflecting the business environment and internal control systems…*"
In our view other sources of information and risk processes are therefore needed to increase risk sensitivity.

The SMA is size and loss sensitive but not risk sensitive. It does not take into account the information from internal risk assessments and therefore does not account for any risks for which a loss has not materialised.

i) **SMA capital levels do not take into account management actions**:
Management actions such as the investment in policies, processes, controls, governance, and divestment of a business or risk transfer are absent from the SMA.

Notably losses relating to divested or otherwise discontinued activities must be removed from the Loss Component and the Internal Loss Multiplier calculation because such losses will no longer recur. The SMA should make a clear statement regarding the application of data relevance checks (like CRR §322 (3) f)). A bank's risk profile is better reflected in the Loss Component if irrelevant losses, e.g. from discontinued business activities, are removed from the data time series.

j) **Loss data under the SMA:**
In order to ensure comparability, simplicity and harmonisation, we believe it is important that some concepts and procedures stated under section 6.1 should be subject to further clarification in order to mitigate any unwarranted discretion in the application of the loss data criteria:

- More clarity regarding the way the loss value should be computed for the Internal Loss Multiplier (ILM) purposes (e.g. gross loss minus the direct recoveries, provisions or reserves accounted – paragraph 43);
- Increase the minimum gross loss threshold from €10,000 to €20,000;
- Definition of concrete and observable criteria to assess the data quality requirements defined for ILM purposes;

- Clarity about the ILM computation periodicity;
- Eliminate losses arising from divested or discontinued business or product lines. The EBF proposes to remove from the loss history those significant losses that will not happen again in the future (i.e. due to discontinued business, success in remediation actions, change in law, etc). This removal could obviously follow a due process in which, for example, after the bank has analysed in depth the loss, an independent auditor reviews all the facts and circumstances for doing so and the Supervisor agrees to it. Of course guidance would be needed to promote a level playing field in this respect.
- In addition, "rapidly recovered losses" should be explicitly excluded from the Loss Component calculation.
- Furthermore, although we agree with the restriction to include only material "pending losses", we believe that the materiality should be clearly defined as well as the "time period" to assess it.
- As a general rule, we believe that "Timing events" should not be included in the Loss Component.

k) Loss data should be included on a net basis
Loss data used for the calculation of the Loss Component should be calculated net of all recoveries.

- Loss Data used for the calculation of the Loss Component should be explicitly considered under net terms by taking into account all non-insurance recoveries allowing to net recoveries from the SMA loss data set. This point is absolutely important and crucial in particular for payment cards business where, in addition, recovery system is ruled and controlled by the international circuits (known as "charge back" operating rules).
- Loss Data used for the calculation of the Loss Component should be netted from insurance recoveries at least in case they have occurred within one year from the claim notification to insurer.

l) Consider Operational Risk mitigating factors with Haircuts
The methodology proposed by the Committee does not consider the effect of risk mitigation interventions and the protection provided by insurance policies. Risk assessment will be improved by allowing banks to deduct provisions and insurance recoveries from loss data used in the Loss Component. In addition, a good internal control framework (as described below in the "Effective Risk Management" point under "Other matters of concern") should be taken into account as a Risk Mitigating factor.

The insurance industry provides banks with efficient cover against certain large unexpected operational risks. Insurance performs a crucial function within the financial system, ensuring certain material risks are transferred and diversified efficiently across the financial industry, contributing to the system resilience.

Maintaining insurance is a recognised Pillar 1 capital mitigating technique in the current regulatory framework as a sound way to ensure risk-sensitivity is enhanced and good behaviour promoted. Such insurance cover may only be offered where risk controls are in place, again recognising the risk management aspect.

We propose to include insurance in the SMA by incorporating a new optional insurance component as outlined in Appendix 3.

Relief should also be allowed for the existing pricing of operational risk into certain retail products (e.g. credit card interest rates) or with RAROC initiatives including risk-based pricing within Credit.

> **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 notion that the alternative proposal aims to set out an upper limit to the Internal Loss Multiplier, provided this cap is effectively calibrated to avoid a disproportionate capital impact. Having a minimum and maximum limit will reduce the variability of capital outcomes across banks.

As observed in the alternative method described in Annex 2 of the Consultative Document, it should have both a minimum and maximum limit in order to reduce the variability of capital outcomes across banks. As currently proposed, the ILM formula only provides a minimum which has been set around 0.541 (as stated in paragraph 34 of the CP).

Other matters of concern:

- **Basis of new approach**
  The EBF would like to know how many banks have been taken into consideration in the sample used for current calibration of the proposal. In the October 2014 consultation, we noted that the number of banks in the QIS significantly reduced from 270 to 89 banks. At present there is no transparency over the actual data used to facilitate informed challenge on the calculations/assumptions made.

- **Enhancing a level playing field**
  The EBF believes that the SMA does not fully achieve the desired level of comparability. On the one hand, the replacement of all four methods currently in use by a single "one size fits all" approach does not properly capture the different operational risk levels of different business models, different business lines and different countries. The main events of operational risk can be closely related to the specific regulatory and legal environment of each country, such as conduct issues in UK, fine amounts in USA, employment rules in Brazil, etc. On the other hand, the measurement of some elements of the SMA formula may differ among banks; there is no clear/homogeneous definition of what should be considered an operational loss for the Loss Component; there might be different accounting criteria for booking those contingent losses or banks in different countries might even apply different accounting GAAPs that would affect both the Business Indicator and the Loss Component.

  o The proposal should link the definitions of BI components to IAS (International Accounting Standards) and IFRS (International Financial Reporting Standards) so that all jurisdictions have the same references.

- o In the proposed SMA approach the level of provisions is computed for calculating capital requirements. While theoretically the level of losses experienced could be an indication of the unexpected losses a bank might incur, provisions should be deducted in a bank's modelling for operational risk, being a representation of expected losses. In the AMA models provision charges are taken into account; however, they can be then deducted from the capital charge measurement as expected losses, to avoid double counting of the final capital requirement.

  This approach penalizes relatively more the banks which have more conservative provisioning. It is worth mentioning that there is no uniform provision treatment among jurisdictions, furtherly challenging the comparability of measures.

  In addition, the treatment is even more unwarranted since provisions accounted for in the P&L against operational loss events are double counted, both in the BI and Loss Component formulas, unduly increasing the overall capital charge.

- **Contribution to simplicity and comparability and risk sensitivity**
  We agree that the use of gross income to determine operational risk (OR) capital is flawed. However we query whether the newly proposed coefficients provide a more relevant quantitative correlation to the actual risk profile of an institution. In particular, the Business Indicator to be calculated in order to determine the BI Component of SMA methodology is not deemed to be risk sensitive and is proven to be strongly correlated to the Gross Income previously adopted.

- **Effective Risk Management**
  The EBF is concerned that the SMA proposal is very much capital focused. Capital is not the sole solution to improved operational risk. The purpose of the Basel framework has been to encourage strong risk measurement *and* management. Sound operational risk management includes having a strong control framework in place, with associated policies and processes; embedding this in the organisation; governance of same; assessing internal and external loss data; Pillar 2 interaction and stress testing indicators. Firms should be encouraged to continue investing in such sound operational risk management practices and have it recognised under Pillar 2.

- **Model experience**
  The EBF considers that OR models have not been given time to prove themselves. They were barely in existence when a period of severe financial crisis and recession arose worldwide. OR models have not therefore had a "normal" period in which to be assessed. Other major industries have developed effective OR models over many years; for example the energy, pharmaceutical and airline industries. Market Risk models have been in existence for some decades. We suggest that existing models are not completely disbanded but that an effort is first made to refine them.

- **Differentiation of BI coefficients by Business Lines**
  In order to make the Business Indicator component more linked to the operational risk exposure of a bank, different parameters should be considered, keeping the principle of current standardized formula but with different percentages applied to different business lines

- **Timing**

  The EBF would appreciate clarification on the expected timeframe for implementing an SMA approach. This is particularly relevant as the proposed approach would mean a significant increase in capital requirements for which banks would need to plan.

  Overall, the proposed SMA approach would have a very significant impact in terms of capital requirements, which would be translated into the real economy through the pricing of financial instruments, influencing strategic decisions.

  Based on these relevant points the EBF support a revision of the SMA along the lines we propose in this response to the Consultative Document.

![EBF European Banking Federation logo]

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APPENDIX 1

SMA coefficient sensitivity

An analysis has been performed[2] on the coefficients assigned to the Business Indicator buckets in order to compute the BI Component.
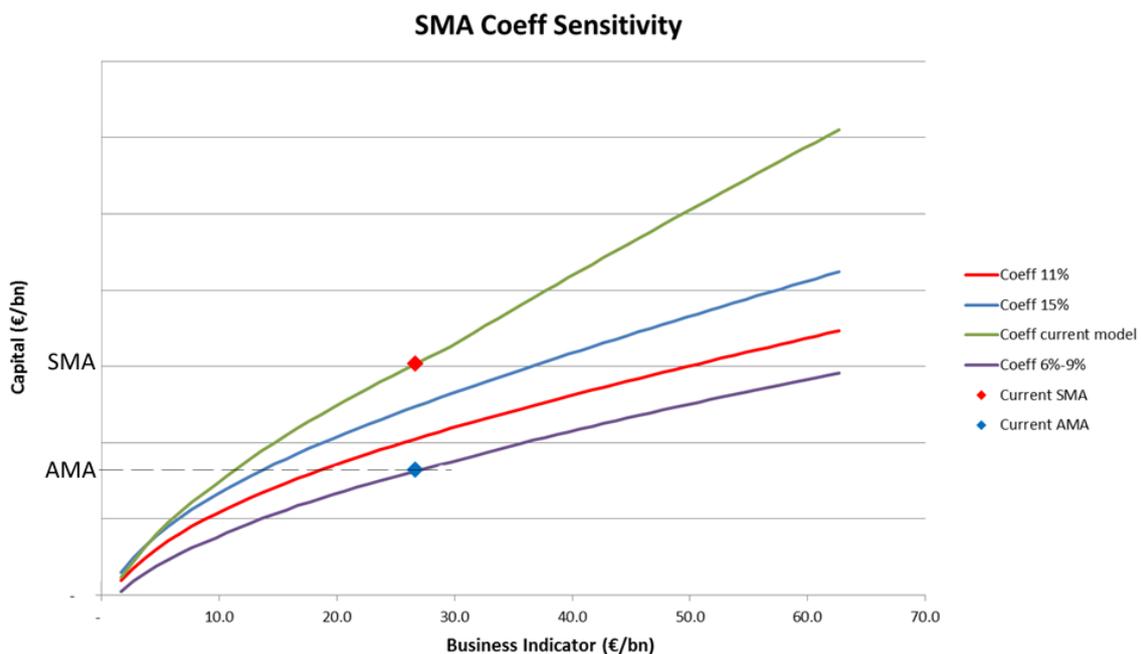

Figure 1: SMA sensitivity to coefficients

Considering the same BI buckets structure and varying the coefficients, it can be observed that, in order to reach the current regulatory capital computed through AMA model[3], the coefficients should be decreased to values lower than the range of 6% to 9%:

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[2] The analysis has been performed by one of the most significant AMA Italian banks.
The hypothesis is that the Loss Component has been fixed using the last 10 years data of the bank (2006-2015), while the business indicator is varying. The Business Indicator of the bank is around € 27 bn. You can observe that, for matching the current AMA bank capital requirement, it is necessary to recalibrate the BI Component coefficients to the range 6%-9%. Moreover, this proposal includes a more gradual coefficients progression, making less significant the super-additivity issue.

[3] This significant AMA Italian bank shows an SMA ratio to AMA of around 185%. On the basis of ORX benchmark, we observed that the average ratio for European banks is around 180%. As a consequence, we can state that the proposed recalibration of the BI Component coefficients would make the SMA impact nearly neutral on average. As stated in BCBS Consultative Document: "The objective of these proposals is to not significantly increase overall capital requirements". Therefore, we think this objective would be met with the proposed recalibration

BI		Coefficient
-	1,000,000	6%
1,000,000	3,000,000	7%
3,000,000	10,000,000	7%
10,000,000	30,000,000	8%
30,000,000	-	9%

Figure 2: BI reviewed coefficients

The bucket coefficients proposed in the SMA consultation are aligned with those considered in the first consultation document published in October 2014. In that case, it seems the coefficients have been calibrated considering a data set composed mainly of non-AMA banks. This suggests that a downward recalibration of coefficients is needed in order to take into account the disproportionally negative effect of the new approach on AMA-compliant European banks.

Figure 1 - SMA sensitivity to coefficients shows the comparison between the proposed SMA position (green line) and the capital requirement obtained by setting the coefficients in order to reach AMA capital level (purple line). In blue and red are reported the capital setting fixed coefficients, 11% (lowest BI coefficient considered) and 15% (under to the BIA approach, for benchmark purposes) respectively. In all cases, the capital would be higher than under the current AMA model, highlighting the very weak relation between the proposed Business Indicator measure and the bank risk exposure evaluated via internal risk models. Against the backdrop of this simulation it is clear that significant changes will occur to the current capital requirements for which carefully consideration must be given to a phase-in process "possible gradually scaling of the SMA components".

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APPENDIX 2
Why the Business Indicator cannot be considered as a good proxy for OR Exposure.

The Business Indicator construction has been detailed in the BCBS paper issued on October 2014. In order to find an indicator which better captures a bank's risk exposure, several statistical analysis have been performed by BCBS, comparing the explanatory power of 20 candidate indicators built from balance sheets and/or income statement items. From the analyses, the Business Indicator was found to be overwhelmingly superior in capturing a bank's operational risk exposure, following a non-linear relation.

However, analyses have been performed considering only a limited sample of banks. Outlier observations have been excluded from the data set obtained with the OpCaR calculator, in order to avoid that the estimates were affected by very few large points (mainly representing AMA banks) rather than by the bulk of the data, which typically identify BIA or TSA/ASA banks. Specifically, the banks with an extremely large value for BI (BI > €30bn) or very large ratio with OpCaR (CaR/BI > 50%) were removed by the sample.

In this way, the selection and construction of the better proxy indicator have been done considering not all banks, but excluding all above AMA ones. Indeed, the percentage of non-AMA banks represents about three quarters of the banks in the sample.

The aim of the October 2014 consultation paper was to review the simpler approaches (i.e. TSA and BIA), but in the March 2016 consultation paper the withdrawal of AMA in favour of the use of a standardized measurement has been considered, so it cannot be consider as the better proxy indicator for bank's operational risk exposure.

Therefore, the Business Indicator is an aggregation of P&L items which capture systemic risk profile at a certain point in time, but neither it is a meaningful financial indicator (i.e. it sums up several budget items without resulting in a single value adding financial number, making it difficult to estimate for an outside market participant) nor it actually represents the level of operational risk of a bank. Operational Risk is by nature mainly "behavioural" (its main trigger being conduct risk) and its exposure cannot be caught by financial statement items as it is not embedding any information on the control system in place in each bank.

Moreover, in absence of a full convergence between accounting principles applied worldwide and a planned harmonization process, the BI would be barely comparable across banks, as long as credit institutions, applying IAS/IFRS rather than US-GAAP (just to mention two well-known examples), account differently for operating/fee income and expenses.

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APPENDIX 3
Proposed Insurance Component

This would be incorporated as follows, as an ex-post percentage correction:

$$SMA\ Capital_{net} = SMA\ Capital\ \times (1 - Insurance\ Component)$$

The insurance component will denote the percentage of capital that can be off-set by a bank's use of an eligible insurance policy. It is calculated using a cap of 20%:

$$Insurance\ component = \min(20\%, \delta)$$

The δ parameter could be calibrated considering an "admissible insurance contract" which could be more standardized, with the following features:
- Material risk retention;
- Disclosure requirements to the insurance market and regulator;
- Insurance counterparties must have a minimum credit rating of "A" or equivalent;
- Claims protocol to facilitate timeliness of payment within the insurance contract;
- Clarity of coverage:
  - Based on traditional insurance solutions enhanced to provide clarity of cover and payment certainty
  - Clear contract wording with a coverage clause considering all Operational Risk above a threshold arising out of any Operational Risk events subject to a pre-agreed set of exclusions:
    - Credit/Market/Strategic/Reputational risk events
    - Deliberate corporate acts
    - Regulatory fines and penalties
    - Known prior acts
    - Claims arising out of liquidation/bankruptcy/insolvency/schemes of arrangement
    - Seepage, pollution or contamination
    - War/Nuclear

The important factors to consider for computing the insurance benefit are the policy limit L, deductible D, and a standard haircut H covering the theoretical impact of the limit on capital, any mismatch in cover, counterparty default or delay in payment:

$$\delta = \frac{H \cdot L}{SMA\ Capital} . f(D)$$

$f(D)$ is an adjustment depending on the chosen deductible, ensuring the benefit decreases as the deductible increases.

The haircut H can be calculated by the Basel Committee with the QIS data as part of the SMA final calibration.

The methodology should be simple and transparent, relying on a number of logical and standard factors that can be easily estimated for the banks wishing to benefit from insurance mitigation.

The methodology should provide for the integration of catastrophic loss insurance solutions which could be purchased in addition to current working layers (i.e. day-to-day policies) that are purchased to mitigate more specific and expected loss events.