Appendix D

ISDA's comments on Section 2.V of CP3- Operational risk

Scope of comments

ISDA's main comments regarding the rules on operational risk focus on the Advanced Measurement Approach (AMA), which is a major focus of industry development effort.

We note, however, the following points with regards to the overall framework for operational risk.

Operational risk framework

First, the incentives to progress to the AMA are still not clear or proven, particularly if financial groups were to face the management burden of each legal entity having to qualify for the AMA. (We discuss this issue further below – see "AMA Issues", section "2".) Moreover, for some types of firm, there will also be a systematic *dis*-incentive to move to the Standardised Approach, given that the beta factors for some business lines are higher than the alpha factor agreed for the Basic Indicator Approach. Equally, this level of beta means that some firms will feel a greater pressure to move to the AMA than others. Fundamentally, in presuming that firms generally ought to be on the AMA, the Accord has gradually but inexorably moved away from an earlier consensus point that firms should be free to adopt the approach that provides the most cost-effective means of risk management and to move to a more advanced method only when this delivers clear risk-management benefits for the firm. We consider this nexus of structural issues to constitute a weakness in the Accord.

Also with regard to the role of the AMA, it is publicly acknowledged that, in spite of considerable joint work by industry and supervisors since the time of the first consultation in 1999, the advanced-level rules for operational risk remain much less prescriptive than those covering credit or market risks. To a significant extent, this is inevitable and, given the need to structure a framework that truly reflects the diversity of current and evolving risk management practice, welcome. The net result, however, is that, in the field of operational risk more than in any other area of the Accord, the impact of the rules will depend on issues of implementation, particularly as regards the AMA. To a significant extent, these issues will inevitably be a matter for discussion between individual firms and their supervisors, as a fuller understanding of AMA practice develops. In these circumstances, the effectiveness of the Accord will depend on a credible, explicit commitment to international co-ordination of supervisory application of the operational risk rules, combined with transparency standards regarding AMA approval. ISDA considers such a formal commitment to be a necessary integral part of the rules.

We believe it is essential more generally to provide a clear commitment to revise any elements of the operational-risk rules that may prove sub-optimal, as experience of the framework and techniques for operational risk management develop.

AMA Issues

Overall, ISDA welcomes the continued progress on important issues and believes that further dialogue will help ensure the effectiveness of the regime for operational risk. We attach our earlier letter to the RMG by way of background discussion on the issues within the AMA on which our members have focused, namely:

1. General
2. Consolidation/Allocation
3. Correlation
4. Risk Mitigation
5. Soundness Standard

1. General

ISDA fully expects further evolution of methods for managing and estimating operational risk (with the strong likelihood of more creativity on the part of firms as and when more immediate compliance deadlines linked to the introduction of the new rules have passed). ISDA believes that the Risk Management Group conference on 'Leading edge issues in measurement of operational risk' in May 2003 demonstrated not only common ground between the main categories of approach but also a significant degree of diversity as to how techniques within an individual firm's overall approach may be combined and how the relative emphasis of such techniques may legitimately vary, over time as well as from firm to firm.

The current draft rules focus on four key elements of an advanced approach to operational risk: internal data, external data, scenario analysis and environment/control factors. Firms "must" use each of these (or satisfy equivalently worded constraints). ISDA believes that this sort of formulation places too much emphasis on the means, rather than the end objective, when (i) further new techniques may yet evolve and (ii) where, as stated above, there should properly be flexibility about the ways in which firms "use" techniques, including their relative emphasis.

We stress that we do not oppose the naming of these techniques in the rules. We see potential value in all of them and believe that is quite right that firms be expected to demonstrate to their supervisors a thoroughly considered evaluation of each of them and the information they yield. We simply discount any suggestion that they can be the subject of a fixed standard.

Specifically on "business environment and internal control factors" (paragraph 636), we note that what are commonly referred to as "Key risk indicators" are not generally viewed as a purely quantitative tool, if at all, and that the rules should avoid associating them with a "risk *measurement* framework" [ISDA's emphasis].

More generally, ISDA believes that a key objective in implementing the AMA rules will be to avoid unwarranted volatility in individual firms' capital requirements and that the AMA must accordingly be policed in a manner consistent with this objective. Rules that may be interpreted in a rigid way could only increase the chance of such volatility.

Taking all these considerations into account, we strongly suggest that the Risk Management Group revise the language along the lines that, in order to demonstrate compliance with AMA, firms should undertake a considered evaluation of the applicability of these four elements, and any others the firm considers relevant.

2. Consolidation/Allocation

ISDA continues to advocate the principle of regulatory acceptance of firms' allocation by jurisdiction of capital amounts calculated at group level. As outlined in our letter of May 20th, ISDA believes that this will be essential if the AMA is to be practicable.

The Risk Management Group has asked for more specific suggestions as to how such allocations could be determined and ISDA believes that:

1) distinct solutions developed by individual firms are likely to be developed and should be eligible for consideration;
2) in the meantime, a feasible and, crucially, verifiable solution exists in the form of gross income.

As and when other potential means of allocating capital are developed, it should be possible for firms to have these considered by their supervisors. In the meantime, ISDA members believe that there is greater risk-management benefit in focusing resources on the fundamental issue of determining, on a group-wide basis, an appropriate aggregate capital requirement.

It should, however, be noted that using gross income as the basis of allocation would not, for example, preclude the simultaneous use of key risk indicators and management judgement in identifying relative strengths or weaknesses in control among group entities, and that these other techniques could for example be used as an overlay or complement to the use of gross income. With any mechanism[s] of allocation, the key issue in allowing their use would be that their effectiveness in apportioning risk capital was periodically reviewed by the individual firm.

ISDA recognises that there will need to be a dialogue involving host-country supervisors in the case of systemically significant institutions. Home-country lead supervision should, however, remain the norm. This point is addressed in more detail in our letter of 20th May.

3. Correlation

Regarding correlation, ISDA warmly welcomes the progress made in adapting the requirements to the realities of operational risk management. What seems inconsistent with this, however, is the reference to correlation in paragraph 635 of the draft rules, relating to scenario analysis.

As with the issue of “correlation” more generally, we continue to believe that the term “dependency” more appropriately reflects the range of issues at stake here. The underlying issues appear to be the potential for multiple events arising from a common cause or the co-incidence of multiple events from distinct causes. The application of a “variance-covariance” approach to this set of issues is unlikely to yield risk-management benefit.

We take this opportunity to stress our belief that, consistent with our points above on allocation, it is appropriate for supervisors to recognise “implicit” correlations captured in group-wide AMAs, subject to reasonable checks on the credibility of such estimations.

4. Risk Mitigation

The limited recognition of risk mitigation, both within the AMA and across the range of operational risk approaches, constitutes a shortcoming that ISDA believes will need to be rectified. ISDA fully supports the development of appropriate criteria to ensure that risk mitigation is effective, but believes that this combined with supervisory review should be sufficient to allow proper recognition of a potentially useful technique, of benefit to individual firms and to the system as a whole.

In particular, ISDA believes there is a policy advantage to be gained in keeping the door open to alternatives to insurance, which could include capital-market structures that provide funded protection to firms, thereby overcoming potential concerns about speed of payment. It questions the policy advantage in excluding such techniques.

5. Soundness Standard

It seems to us highly likely that, simply by dint of being specifically mentioned, the 99.9% confidence level will, at some stage, become a “hard” standard, at least in some jurisdictions. In an environment where various types of AMA are contemplated as potentially meeting regulatory standards, this would clearly be inappropriate.

As with the AMA overall (see “1” above), we therefore believe that it would better reflect the apparent intention with regards to the soundness standard to stress the end-objective (soundness) rather than the means (99.9%). We appreciate that the RMG has already made helpful changes in this regard and offer this suggestion as something we believe to be the logical extension of that development. Specifically, we recommend to the RMG greater reliance on the language in paragraph 622 of the draft Accord, that requires of firms a standard that is “credible and appropriate” in estimating capital for operational risk.

On a related point, while it is right that a firm should be expected to collect data on material losses it seems to ISDA more appropriate that the exact threshold be a matter for the firm to determine and, as necessary, justify.

Conclusion

In the above, ISDA has focused on those specific areas where it believes the latest draft of the Accord can be improved. Clearly, much progress has been made, particularly as compared with the first stages of the consultation, in 1999. ISDA believes that the single biggest advance has been to explicitly recognise the need for a significant degree of flexibility to be built into the rules. Our view is that much will still depend on two, inter-related factors that should be recognised explicitly in the Accord:

Implementation, as mentioned above, requiring a formal co-ordination policy among supervisors;
Revision of the Accord’s operational risk framework, based on review of its overall effectiveness within 2 years of implementation.

As mentioned in the section on consolidation/allocation, the presumption that lead supervision will generally fall to the home country will be a pragmatic measure that we believe will aid implementation.

ISDA thanks the Basel Committee for the opportunity to comment on this important aspect of the capital framework.

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Roger Cole
Chairman, Risk Management Group
c/o BIS

Dear Roger,

Looking ahead to ISDA's planned meeting with the Risk Management Group in New York on May 28th, we thought it would be helpful to outline some of the key issues that member firms would prefer to discuss, and to briefly explain their position on these issues. In doing this, we have as much as possible framed issues with reference to the Basel Committee's third Consultative Paper, "CP3".

In meeting with the RMG, ISDA would welcome a focus of discussion on four main areas:

1) **Consolidation/Allocation**
2) **Correlation**
3) **Risk Mitigation**
4) **Soundness Standard**

We also include some additional points, on the credit-operational risk boundary, KRIs, and the Standardised Approach.

Overall, ISDA welcomes the continued progress on important issues and believes that further dialogue will help ensure the effectiveness of the regime for operational risk. Our comments below focus exclusively on issues where we believe further discussion is merited.

The RMG will note that a theme, apparent in our comments on both the soundness standard and the Standardised Approach betas, is the insufficient incentive to make the investments necessary to progress along the continuum of approaches outlined.

Looking ahead to implementation, and given the investments required, ISDA would appreciate assurance from RMG members that, subject to reasonable checks, firms should have a realistic prospect of moving promptly onto the AMA.

1. Consolidation/Allocation

ISDA is convinced that the AMA will simply not be practical without the ability to calculate capital requirements at group level and allocate (downwards), per jurisdiction.

Key factors restricting the ability to calculate individual AMA requirements for multiple entities within a group are as follows:

- Data insufficiency at the level of individual entities (or, for that matter, groups of entities) will be particularly acute, given that this will be an issue even at group level.
- To the extent that there is a failure to recognise the significant levels of risk-diversification that firms achieve, excessive capital will result, since the sum of the individual-entity capital requirements is likely to total considerably more than the group requirement. (In connection with this, please see our discussion below on correlation.)
- There would be a major and, in a group context, duplicative management burden, if each entity (or group of entities) was required to meet AMA standards in full.

ISDA believes that the practical solution to this dilemma is to accept that firms calculate capital at group level and allocate per jurisdiction. This provides an appropriate basis for discussion with national supervisors, given their responsibilities to ensure capital adequacy in relation to entities (or groupings of entities) incorporated in their jurisdictions. Yet it remains workable for firms.

Any insistence on full AMA calculations at subsidiary level may, especially for the reasons outlined above relating to lack of recognition of diversification, tend to increase the incentive for firms to move towards a branch structure. This would not necessarily be beneficial for the system overall.

Naturally, a firm's allocation methods must be systematic, transparent and accessible to all directly interested supervisors. As with other issues, in assessing the adequacy of allocation methods, the most practical arrangement will be for the firm's home-country supervisor to lead. This will minimise duplication of effort and maximise co-ordination of review.

2. Correlation

ISDA members welcome the amendments made in CP3 to the language on the treatment of correlation under the AMA. In order to help create an environment in which firms can develop a true representation of risk levels, we believe it essential that the Accord avoid any language that has the effect (whether intended or not) of prescribing a single, rigid mechanism for determining dependencies.

This is especially important because firms may not necessarily divide their business up so as to generate separate loss distributions requiring aggregation. It is entirely consistent with the management of operational risk to assess risk at a firm-wide level. ISDA opposes any requirement, explicit or implicit, to calculate risk numbers for many distinct entities (and/or risk types, and/or products) and sum them. It believes that such a procedure would systematically inflate a firm's capital requirement and inevitably, therefore, act as a *dis*-incentive to granularity in risk calculations.

Where separate loss distributions are generated, for statistical reasons a simple correlation co-efficient is unlikely to be available or appropriate. (Essentially, this is due to the non-normal nature of operational risk distributions.) Outside an LDA (for instance, in predominantly scorecard approaches), a strict statistical approach to correlation may be simply irrelevant.

For these reasons, ISDA prefers the broader term 'dependency'. In ISDA's view, the approach to correlation ought to be consistent with the AMA more broadly, that is, a variety of possible approaches should be accommodated.[1] It is preferable for the development of the discipline of

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[1] *Any of a number of statistical or non-statistical techniques might potentially be of value in relation to AMA approaches in estimating the likelihood of certain events occurring a) simultaneously or b) as a result of each other; eg, Common Shock, Factor Analysis, Copulas and Correlation. The terms 'dependency' and 'dependency analysis' are offered as a generic term covering the range of such techniques.*

operational risk management within the AMA that firms justify a number that they themselves have estimated, rather relying on a crude and conservative assumption of '1'.

CP3 seems to reflect an understanding between the policy specialists amongst both regulators and firms about what is intended by 'correlation'. But, as the framework is implemented, there is a concern that 'correlation' may be limited to its mathematical interpretation. In ISDA's view, therefore, in addition to the introduction of the term 'dependency', further amendments are required to limit this risk, specifically with regards to the language referring to "validation" and to a "high degree of confidence". Both of these terms tend to suppose a particular, statistical approach.

3. Risk Mitigation

ISDA notes and appreciates the RMG's continued willingness to work on this issue in support of recognising insurance, including the development of clear and fair standards against which the acceptability of a given insurance policy may be tested. Recognition of risk mitigation helps the new capital Accord to be a) risk-sensitive and b) forward-looking, which must surely be significant advantages in ensuring that it has long lasting relevance.

In this context, ISDA believes the following points are crucial:

- Within the AMA, limiting recognition to 20% of gross exposure, on top of limiting recognition to AMA firms, reduces the incentive for insurance firms to develop products that meet particular requirements.
- A cap on aggregate recognition duplicates the effect of the haircuts proposed for individual contracts.
- CP 3 states that insurance is to be provided by a third party. We recommend a change in the wording, such that the capital held in insurance captives is also recognised.
- There appears to be no reason to rule out review and potential change, as applicable to other figures in the draft Accord.
- It is ISDA's understanding that, as and when capital market instruments emerge with risk-transfer features similar to insurance (and which could include funded protection), they can be discussed with national regulators.

We note that the limitations on recognition of insurance may well persuade a bank to 'self-insure' against certain risks, by treating the risk as an expected loss (which may, in principle, be excluded from the regulatory capital requirement). The apparently unintended consequence of this is to limit the protection in fact afforded in the rare instance of there being a larger-than-usual loss.

4. Soundness Standard

ISDA believes that the approach to the soundness standard is helpful to the extent that it accommodates practical considerations around estimating susceptibility to operational loss. However, members continue to have concerns about this issue, at a conceptual level.

A 99.9% event is, in the context of a one-year time horizon, a) extreme (as it may be thought of as "1-in-1000 years") and b) will inevitably entail a chronic lack of data. We stress that this is not purely a temporary problem. It is true that, for some types of operational risk event, this problem may be, or become, less acute. For such risks, for reasons of internal risk management, firms may well wish to model to this high standard. But the nature of other operational risk events – which can be of very low frequency and unrepresentative of future exposures – means that, overall, the standard is not practical, since for these types of risk it may never be feasible or meaningful to model to this level.

We note that this appears to be implicitly acknowledged in the inclusion of techniques other than loss data modelling (especially scenario analysis) as required elements for an AMA. We should not forget, either, that a lack of data may be a positive sign, indicating an absence of loss events, rather than simply a lack of records.

ISDA acknowledges that the language associated with the soundness standard already appears to offer some flexibility. However, in order to give the right emphasis, ISDA suggests that the final Accord rules should invoke a “credible and appropriate” standard (as per paragraph 622 of CP3), making the reference to 99.9% and a one-year horizon at most a footnote.

Paragraph 64 of the ‘Overview’ paper attached to CP3 refers to “enhanced opportunities for the industry to assist in the development of proposals for aligning regulatory capital requirements with sound industry practice”. ISDA believes that the soundness standard is an issue where continuing discussion on alignment will be fruitful.

Further Points

Credit-Operational Risk Boundary

ISDA would appreciate greater certainty regarding paragraph 633 of the draft Accord and particularly the limits on requirements to capture “operational risk” embedded in credit or market losses. ISDA accepts that tracking operational events in the credit area is indeed a good practice, but that a) mandating it as a regulatory requirement is excessive and b) even when it is presented as a good practice, it requires the enunciation of a clearer standard.

While the example quoted in paragraph 633 (collateral management failures) is instructive, the border line is not as clear as it should be. Consider, for example, a loan to a company that turns out to fail for reasons of fraud but where the loan itself is not fraudulent. Assuming this would not be required to be included in an operational loss database, it is not clear (from paragraph 633) by what criterion this is so.

We note, also, that it would be burdensome for firms to have to capture losses twice, through two, essentially duplicative processes (one for credit risk management and one for operational risk), when some losses may not necessarily merit inclusion in an operational loss database.

Key Risk Indicators

In addition to the above issues, the ISDA Operational Risk Working Group has been discussing a range of implementation issues. It considers it timely to note that there are a number of points in relation to the use of control factors/Key Risk Indicators that will be worth clarifying, in the light of the rules as they currently stand. It would welcome RMG comment on the value of such work (some but not all of which might admittedly be primarily of relevance in national discussions), whether within the time frame of the current consultation or over the longer term.

Standardised Approach

ISDA continues to believe that it introduces insufficient incentive to move to the SA to have any beta factors higher than the alpha factor that applies under the Basic Indicator Approach.

Conclusion

In conclusion, ISDA welcomes the continued progress towards a workable regulatory capital regime for operational risk within the context of a revised Accord. We especially appreciate the flexibility shown on partial use of AMA.

Overall, however, ISDA believes that, in order to be truly effective, the rules should also take into account the issues highlighted here; and welcomes the opportunity to discuss these more fully with the RMG, in New York and during the remainder of the consultation period.

Yours sincerely,

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