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Mr Nicholas Le Pan
Chairman, Accord Implementation Group

Mr Roger Cole,
Chairman, Risk Management Group

30 March, 2004

Re: “Principles for the home-host recognition of AMA operational risk capital”

Dear Nick, Dear Roger,

ISDA has taken note of the publication in January 2004 of the above BCBS paper, which concerns an issue of great relevance to the implementation of the Advanced Measurement Approach to regulatory capital for operational risk. While the paper is not formally labelled a consultation, ‘enabling’ language is proposed. This is new to the draft Accord, while the paper raises a number of points that industry members believe merit some commentary. Our preference would be to recast the approach set out to home-host allocation. At a minimum, we believe that the approach should be clarified in certain respects.

First and foremost, we reiterate our belief that the AMA – with its greater potential for risk-sensitivity and its relatively high associated standards of risk management – may cease to be a practical or cost-effective alternative for a significant part of the financial services industry, if the principles as set out in the paper are followed. While the paper offers some welcome accommodation of the principle of allocation (and, in Principle 4, some acknowledgement of the practical challenge of calculating multiple AMAs), this does not alter the economics at stake or the management burden.

The economic effect of diversification (and scale) is poorly reflected. In fact, if multiple subsidiaries are calculating an AMA requirement to a 99.9% confidence level, then the sum of those various requirements will end up as *more than* the 99.9% being targeted. Moreover, an obligation to calculate separate AMAs for multiple group entities will not only overstate risk capital requirements across that group. Particularly for some types of AMA, it may also still add significantly to management burden (especially given a natural and logical tendency among firms to assess operational risk by business line rather than by legal entity), without necessarily providing any clear benefit in terms of improved risk management. (A key tenet of the draft Accord framework for operational risk has, of course, been a central operational-risk management function – a consideration with which the ‘Principles’ ultimately appear to be inconsistent.)

These effects by themselves could easily be sufficient to influence firms’ willingness to adopt an AMA approach for group entities – the relative attraction of the Standardised or Basic Approaches will increase, yet these approaches remain insensitive to operational risk. Alternatively, the approach set out in the

paper may become a factor in groups' decisions as to the legal structure that they adopt (particularly the balance between subsidiaries and branches).

ISDA is conscious of the concerns that supervisors have regarding the free transferability of capital and their national legal responsibilities. ISDA, however, believes that the framework for operational risk – including the principle of agreement between home and host supervisors as to the allocation methodology employed by a given firm, as well as the principle of supervisory review more broadly – offers ample and proportionate means of addressing the risk at stake. The tools and remedies exist for supervisors to address any genuine shortfall of capital at a subsidiary, without blocking what is the economically more appropriate starting point for determining capital.

ISDA is also conscious of the limited time remaining to finalise the Accord. If, in spite of the considerations set out above, the principles are maintained, then we strongly suggest the following two steps:

- 1) that the 'hybrid' approach be made subject to a formal review within two years of the Accord's publication;
- 2) that the wording relating to the following two issues be clarified as a matter of some urgency, in order that firms may make an informed decision as to how they may implement the new framework for operational risk regulatory capital.
 - “internationally active banking subsidiaries” (draft paragraph 619) – Does this phrase signify that it is only those subsidiaries that are themselves internationally active that will be subject to a requirement to carry it their own AMA calculation?
 - “significant relative to the overall banking group” (619) – ISDA agrees that it is significance relative to the rest of the group that is the issue and that this should not be confused with any other test of significance. The question that remains concerns who will carry out the determination of significance, and on what basis? ISDA believes that it is essential for the smooth functioning of the AMA that an agreed, transparent and explicitly structured standard for significance and process for its determination be set forth in connection with the Accord. Moreover, in addition to any size-based test, in order for a requirement to calculate a separate AMA to apply, there should be a clear and demonstrable case of significant contribution to group operational risk. Simply because a subsidiary accounts for a certain level of, say, gross income within a group, it does not necessarily constitute a significant source of operational risk. Meeting such a requirement to identify subsidiaries that are significant *in operational-risk terms* will help to focus resources where they are most needed.

At the same time, the number of subsidiaries that may be deemed significant *relative to the overall banking group* should, logically and by definition, be subject to some limit. ISDA suggests that, the framing of such a limit be the subject of consultation with industry.

Apart from these issues of terminology, we note the following practical considerations. Co-ordination between supervisors will become a critical factor in the practicability of the AMA. Yet it is impossible for firms to assess how this will function, as it is being treated as though it is purely an implementation issue. On this point, we note that the regime appears to incorporate a host-supervisor veto of a firm's ability to implement an allocation methodology that has already been approved. In paragraph 619, in addition to “demonstrating to the satisfaction of the home *and relevant host supervisors* [ISDA'S emphasis] that the allocation mechanism... is appropriate and can be supported”, AMA banks will require “the approval of their relevant host supervisors [to] use” an allocation methodology. We question the appropriateness of such an additional hurdle, if that is indeed what is intended.

Finally, it is important for firms' ability to prepare for the new regime not only that the process by which co-ordination will occur be clearer. At a finer level of detail, it will also be necessary to ensure that reporting of data, both for model approval and for any subsequent validation, be channelled to the single most appropriate supervisor, which would normally be the home supervisor.

In summary, ISDA believes that the issue of recognising allocations of capital is crucial to the viability of the AMA as a broadly practised standard. At the same time, while the current paper acknowledges and makes some response to the challenges in this area, for the reasons given above, the limits that the paper sets mean that further work on the principles would be highly desirable.

ISDA hopes that you find these comments helpful and remains at your disposal for further consultation on these and other matters concerning the finalisation of the regime for operational risk.

Yours sincerely,

Richard Metcalfe
Co-Head of European Office