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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 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'.

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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.

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,

Richard Metcalfe
Co-Head, European Office,