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Mr. Roger Cole
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30th September, 2002

by electronic mail

Re: 'Sound Practices' and 'Rules' papers

Dear Roger,

Please find attached ISDA's responses on the above.

ISDA will be pleased to take part in any further discussion of these issues with the Risk Management Group, and would in addition welcome any news on industry consultation regarding implementation issues.

Yours sincerely,

Richard Metcalfe
Co-head of European Office

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Annex 1 – Comment on Operational Risk – Rules Language

ISDA wishes to thank the Risk Management Group for the opportunity to comment on an informal basis on the current draft of *Operational Risk – Rules Language* ('Rules paper'). ISDA believes that the rules are, broadly speaking, evolving positively and that the framework can be developed to suit the current and future states of the discipline of operational risk management. The comments below are, therefore, offered by way of focus on the remaining issues that, in ISDA's view, would take the rules closer to this objective. ISDA would, naturally, welcome any opportunity to discuss these issues in more detail with the RMG.

As a general point, while it may not be possible to provide detailed comment or guidance on transitional and implementation issues, we believe that these should at the very least be acknowledged in the Rules, given the novelty of the regime for operational risk¹. Also, ISDA suggests that particular attention be given to continuing review of both these rules and the 'Sound Practices' standards also in development, to ensure consistency of approach, for example with regards to the value and treatment of insurance.

More specifically, going through the paper in order, the following points arise. (Numbers refer to paragraphs in the draft Rules paper.)

3. It is, in ISDA's view, debatable whether firms are, as claimed, "encouraged to move along the spectrum of available approaches".

The TSA offers little if anything in the way of advance in risk-sensitivity, as it assumes that a crude proxy (ie, gross income), with minimal value as a risk-management tool, can be rendered less crude by applying it to subsets of a firm. This logic does not hold and, if anything, the application of a crude indicator to a finer set of activities may further distort the picture of operational risk within a firm. If TSA is to remain as an approach, then ensuring that the betas are not arbitrarily high will be an important component of limiting any such distortions.

At the same time, as we discuss in more detail below, the standards/entry criteria for TSA are set unnecessarily high, in ISDA's view, meaning that for little gain (in terms of either risk management or capital relief) a firm must meet standards that are very close to those applying for the Advanced Measurement Approach. Effectively, this is a barrier to entry, rather than an encouragement.

In particular, based on the numbers currently mooted as beta factors, the Standardised Approach clearly embodies perverse incentives for any firms with a greater than average focus on corporate finance, trading and sales, and payments and settlements. It would be appropriate for beta factors to be no higher than the alpha factor prevailing under the Basic Indicator Approach, this alpha factor being keyed off a proportion of 1988-rules capital on which there is some significant degree of consensus.

A perhaps more logical alternative would be to calibrate TSA at an overall level below BIA, rather than having two barely distinguishable 'simple' approaches calibrated at the same overall level. To the extent that any regulatory exercise generates beta factors that contain a fraction above an integer, it would be appropriate to round these down to take into account in a very modest way the low correlations apparent between categories of operational risk. Thus a preliminary figure of 14.5% for a given business line would become 14% in the final TSA. (See comments below, on paragraph 21c, for a fuller discussion of correlation issues.)

¹ ISDA has begun detailed work on implementation and takes this opportunity to note that industry would appreciate definitive guidance as to how such issues will be consulted on in relation to operational risk.

Again, assuming TSA is retained, ISDA believes that it is essential that firms should, if they choose and if they can meet appropriate standards/entry criteria, be permitted to progress directly from the BIA to the AMA (and, as discussed below, adopt a split approach between the two).

We should also note that it would, in our view, be counterproductive to force firms to move along the spectrum. The choice as to approach should be a free choice based on the firm's philosophy and experience with regards to operational risk.

Moreover, partial use, split such that a firm uses an AMA approach for certain activities and an *aggregate* gross income number for the rest of its activities combined should explicitly be permitted. This is a practical measure that would take into account the fact that for some firms it may only be worthwhile pursuing the AMA for a limited number of business activities and that tracking gross income by business lines for the rest of the firm does not provide enough risk-management value.

More generally, guidance on what is intended regarding partial use would be helpful. In particular, ISDA believes the rules should permit partial use *within* a given business line.

4. A bank should be able to seek regulatory approval to revert to a simpler approach, if it can show good cause.

11. The use of the term "equal" is, in our view, potentially misleading. A more appropriate way of expressing what appears to be the underlying idea might be to say "be a function of", "be based on", or "be comparable to". Any confusion with economic/actual capital calculations ought to be avoided.

In connection with this paragraph, **Footnote 4** introduces what is, in ISDA's view, a worrying level of detail in the potential interventions of supervisors. We believe this footnote should simply be deleted, since it is not in keeping with the overall spirit of the approach to operational risk, namely to allow for i) evolution of practice and ii) the adoption of techniques and frameworks that are suited to the nature and circumstances of individual firms. If this footnote was to remain, ISDA urges the Risk Management Group to reconsider the use of the term "capital numbers", and substitute "approaches". It would also be appropriate to stress that any comparisons between firms should entail the utmost care to respect the legitimate differences between firms – and to determine what are in fact a firm's "peers" – and the inherently and chronically evolutionary nature of operational risk management.

16. Generally, this paragraph sets standards that ISDA views as more appropriate for a firm under the AMA than, as discussed above, what is essentially a mere variant of the BIA.

Moreover, even if they were applied to the AMA, the conditions would be demanding. In particular, paragraph 16 (b) requires that a firm "assess the potential impact that operational risk might have on its solvency". This "potential impact", by being expressed in such an open-ended way, renders it impractical to carry out the assessment required.

Clearly, this issue links into the still unresolved question of what portion of a putative operational risk loss distribution the Basel Committee is trying to ensure that firms capture in introducing a charge for operational risk. ISDA believes that is essential to ensure that the charge does not inappropriately capture extreme, 'catastrophic' loss or loss which, for reasons of differences between firms in control environment, are not relevant to a particular firm.

Paragraph 16 (f) is a further example of a requirement that could, depending on how it is interpreted, prove anomalously high for a relatively simple approach such as the Standardised. In particular, factoring

operational risk into pay and pricing decisions is out of keeping with an approach that is of limited risk-sensitivity.

18 (c). While the thrust of this requirement is welcome, there may be an unintended consequence arising from the use of the term “day-to-day”. A firm will typically not calculate – or even be able to calculate – a number for operational risk on a daily basis.

In 18(e), it would appear helpful to add the word “operational”, to give: “The bank’s operational risk management system....”

In 18(g), we would suggest adding “[...system by] suitably qualified third parties, such as [external auditors...]”.

19. ISDA welcomes as a pragmatic advance in policy the new phrasing with regards to the ‘soundness standard’. Clearly, the use of the term ‘comparable’ raises an implementation issue, on which ISDA would welcome dialogue with the Basel Committee. As a starting point, however, ISDA believes that this terminology is progressive. It would, however, be helpful to have further guidance on the distinction made between catastrophic and other loss events; and on the appropriate ‘holding period’, given the difficulty of translating this term directly from a credit/market-risk context and the variety of risks covered under the operational risk heading.

20. The use of the term “independent” automatically raises the question ‘From what?’ and what, therefore, would constitute independence (and whether that could legitimately be achieved within the same unit, business line, or firm). ISDA believes that the guiding principle in any usage of this term should be that of ‘as independent as is strictly necessary for the situation in hand’. In this instance, that would equate to “model validation that is independent from the construction of the model” and ISDA would consider it helpful to state this explicitly.

21 (a). ISDA welcomes the recognition in principle of firms’ coverage of expected loss by means of reserves, pricing or expensing practices, where permitted by relevant accounting rules. ISDA appreciates the RMG’s willingness to respond to industry representations on this point.

21 (b). This ‘granularity’ standard regarding loss drivers strikes ISDA as aspirational, going beyond what is required even for market risk models. If the requirement were framed in terms of assessment (rather than a feature of loss modelling per se), then it would be still challenging but feasible. As it stands, this requirement appears anomalously high compared to those in paragraph 21 (d). Clarification on what is meant by “loss drivers” (or some illustration thereof) would, in any case, be necessary, in ISDA’s view.

21 (c). While ISDA appreciates the openness in principle to the use of empirical correlations (within the area of operational risk), the ‘all or nothing’ nature of this acceptance could easily result in a firm holding much more capital than is strictly necessary in an area where practice is developing. In many instances, a firm’s *estimate* of correlation may be significantly different from ‘1’ for reasons that can be clearly enunciated and backed up with specific data, even though there may not be extensive amounts of that data to support its position.

In fact, ISDA is firmly of the view that the starting assumption regarding correlations between various incidences of operational risk should – conceptually at least – be zero. This, after all, is why it makes sense to categorise operational risk by business line/event type, as set out in the Rules paper. The reason to categorise is precisely in order to capture very different – and unrelated – forms of operational risk.

Discussions on correlation typically focus on ‘stress’ periods, and this term is indeed used in paragraph 21(c) of the Rules paper. This, however, is not a concept that translates directly into the area of operational risk from market/credit risk. In market/credit risk, price movements/defaults may indeed become more highly correlated at certain moments. In the field of operational risk, there is a) not the same potential for all firms to suffer the same effects at the same time, given that operational risk is endogenous; and b) even within the same firm, the various types of event will be more commonly unconnected. It would be more appropriate to apply (scenario) analysis to the estimation of stresses to correlation.

To illustrate this line of argument, it suffices to consider some representative types of event:

- 1) a rogue-trading event in equity futures in Asia;
- 2) government action over consumer-lending policies in the US;
- 3) credit-card fraud in Latin America;
- 4) clerical error in a correspondent-banking transfer in Japan;
- 5) a flooded retail branch in a European country.

Clearly, the spread of business lines, products, risk types and geographical locations that can exist within a single group, mean that the potential for true and beneficial diversification is considerable.

Over the longer term, it is desirable in policy terms that the regulatory framework accommodates and, indeed, encourages the gathering of operational-risk data at the most granular level possible. Setting overly conservative limits on the recognition of correlation will work against this objective, by reducing firms’ incentive to pursue such granularity.

In connection with this discussion on correlation, it should be borne in mind that the rules currently insist that firms use external data. For reasons discussed below (see comments on paragraph 26), this will tend to make the risk numbers for any given business-line/event type conservative. Constraining the recognition of correlation effects (with which a firm will be very familiar) at the same time as requiring the recognition of potentially extraneous events (with which a firm may legitimately have less familiarity) can easily result in a charge that is based on what amounts to catastrophic risk many times over.

Looking at current practice, from a starting point of zero, firms will themselves typically base capital calculations on a more conservative number, to take account of the rare instances when there is some commonality of cause.

In these circumstances, and subject to a firm providing clear evidence of the nature and effectiveness of the diversification, ISDA believes that it would be appropriate to offer conservatively adjusted recognition of such an (itself conservative) estimate, such that multiple operational risk loss predictions were not necessarily treated additively. A suggested approach would be to ‘split the difference’ between ‘1’ and the firm’s own estimate of correlation (always assuming that this estimate is backed up by evidence of the independence of the risks). The final number would provide a cushion, over and above the firm’s own conservative estimate.

ISDA believes this compromise should only apply until firms can meet the higher standard set out in the Rules paper, at which point they would be eligible for the full benefit of correlation effects.

In connection with the above discussion on recognising correlation effects it is worth noting that these may – quite correctly – be embedded in any firm-wide ‘LDA’ number that constitutes an AMA loss-modelling methodology (just as correlation effects are embedded in Value-at-Risk numbers in a market-risk context). Partial recognition of such effects, in the way that ISDA is proposing, would constitute a helpful intermediate stage in a progression to the full recognition available under the constraints currently set out.

25. It is not clear how an operational risk measurement system would be expected to treat legal risk, which is explicitly mentioned in the definition of operational risk given in paragraph 1 of the draft Rules paper. It would be helpful to clarify if the current paragraph is in fact intended to refer strictly to events set out in the regulatory business-line/risk-type matrix (see, eg, Annex 2, Level 1).

Regarding the requirement to gather descriptive information, the potential legal discoverability of sensitive pieces of such information makes it essential to offer the same safe-harbour protection that is afforded to other records, such as audit notes or medical records. ISDA suggests that provision to this effect be appended to this requirement.

On mapping, ISDA believes that a means of checking on the comprehensiveness of a firm's assessment of operational risk – which is presumably the objective of any such mapping requirement – would be achieved in a more pragmatic and less burdensome way by mapping to relevant regulatory loss-event types rather than business lines. Certainly, mapping to business lines carries no risk-management benefit for firms.

26. Use of external data raises many issues, including that of relevance. Simply because a given firm experiences what may be a catastrophic loss, it clearly does not follow that management at other firms has failed in any way. Nor that a second such event at another given firm means that the remaining universe of firms has deteriorated further. Penalising one firm for the mistakes of another does nothing to strengthen the 'innocent' firm's incentives to ensure effective control of activities and may conceivably weaken them, since the capital benefit of investing in controls will be diluted or even lost.

It would in fact be preferable to require firms to "give due consideration to" relevant external data, since "use" appears to imply its formulaic inclusion in a loss model, which may or may not be appropriate. This 'due consideration' language would in fact be generically appropriate to any of the four sources of information about loss/exposures that the paper stipulates, given the need to 'future-proof' the regulatory framework for operational risk.

Risk mitigation. Risk mitigation properly should be considered as an integral part of "Business environment and control factors", in our view, and should not, therefore, be treated as a separate section of the paper. In that context, it is important to highlight the various options to firms with regards to operational risks, namely: accept, reduce, transfer and transform.

As regards the limit on recognition of insurance, ISDA believes this is inappropriately tight, given that firms have to satisfy stringent requirements set out in the paper, as well as many other requirements more generally, in order to gain access to the AMA.

As stated in the 'Sound Practices' paper (paragraph 36), the principle of risk mitigation is one that is clearly of value in relation to any risk and the limit in the 'Rules' paper on the recognition of insurance rightly does not appear to apply to other possible forms of operational risk mitigation. ISDA appreciates the supervisory desire to be sure of the effectiveness of risk mitigation, but suggests that any floor should be a) temporary and b) for that limited time, set at such a level as to preserve at least 50% of the benefit of risk mitigation, in order not to undermine the incentives to mitigate risk.

ISDA remains opposed to floors on the capital relief available by dint of moving to a more sophisticated approach and requests an explanation of how any such floors are intended to work.

Furthermore, in keeping with the general principles of risk mitigation, provided a given insurance contract satisfies reasonable criteria of the sort in development by the RMG, then it is the net loss that

should form the basis of capital calculations. It is particularly true for certain sorts of event, where insurance markets are well established, that it is a routine matter to receive a pay-out relating to the event within a predictable time frame, as demanded under the draft standards and. In such circumstances, there appears to be no reason why the net figure should not be considered appropriate as the basis for regulatory capital calculations, just as it is for economic capital calculations.

ISDA welcomes the potential recognition of capital-market instruments designed to provide operational risk mitigation. It does, however, believe the RMG would be well advised to review the proposed disclosure requirements in relation to insurance, with a view to expected benefits and consistency of treatment with other methods of risk mitigation.

As regards insurance through captives/affiliates, to the extent that these are insurance-supervisor regulated and not captured under consolidated banking supervision, it would be appropriate and helpful to make clear that, where such an entity is able to cover potential loss through reserves/provisions (as distinct from la ying off risk to a third party), this would be recognised.

Other

One, more general point concerns the definition of loss. In ISDA's view it would be helpful to clarify this, for instance with regards to intra-day losses, which should not be included in a loss database. To attempt to do so would be impractical and, in the normal course of events, would give an inflated number.

Conclusion

By way of conclusion, ISDA believes that the draft rules are evolving in a way which suits the objectives of a capitalcharge for operational risk. The suggestions above are, however, ones which ISDA considers to be important to ensure the coherence and effectiveness of the regime for operational risk. As will be apparent, the way insurance and correlation effects are recognised are key elements on which further refinement would be in order, although it is acknowledged that these are areas where practice is evolving and that they are elements of an overall framework. On correlation, however, ISDA considers it worth repeating a point made in previous submissions, namely that adding a 99.9% number for each of credit and operational risk results in an overall soundness standard well in excess of 99.9%, effectively penalising those firms with a spread of such risks as compared with those whose risk is predominantly in one or other of those areas.

The role and nature of the Standardised Approach also merits further consideration.

As mentioned above, we stand ready to offer the RMG further assistance in discussing these issues and elaborating on the points above, as necessary.

Annex 2 – Comment on Sound Practices for the Management and Supervision of Operational Risk

ISDA is grateful for the chance to comment on the second draft of the paper *Sound Practices for the Management and Supervision of Operational Risk* (‘Sound Practices’).

Overall, ISDA considers that the current draft of the Sound Practices paper is an improvement on the earlier version. ISDA particularly appreciates the responsiveness to industry comment apparent in the elimination of the section on best practice that had been included as Part 2 of the first draft. This elimination appropriately ensures a **focus** strictly on sound practice. Moreover, another key point has been addressed in the current draft, in that the **terminology** is more in keeping with that used in the industry. Industry terminology reflects a balance between flexibility and specifics in relation to the management of operational risk and it is appropriate that sound-practice standards should reflect this operational reality. It is especially helpful that the Basel Committee has, as suggested by industry, generally replaced the term “measurement” with “assessment”.

There remain a few outstanding issues with the standards as currently drafted, which ISDA appreciates the opportunity to bring to the Risk Management Group’s attention. While these mainly concern terminology, we would stress that their importance should not be underestimated. Given that the proposed 2003 Accord intends to fit a new regulatory framework round a practice that has always existed in some form within firms (and which is currently undergoing a significant new phase of evolution), it is vitally important that the framework does not constrain practice or its development.

Another reason why terminology will be a factor is the variety of potential audiences for this paper: from those involved in day-to-day management of (single elements of) operational risk; to those overseeing it at a higher level within the same firm and implementing the structure set out by a non-executive board and monitored by senior management; to those concerned with only the overall risk profile in its broadest outline. Particularly for those in the intermediate of these three levels, clarity will be essential.

In this context, the choice of terminology is a critical factor, as highlighted by the earlier debate over the terms “measurement” and “assessment”. In a similar vein, we would urge the RMG to reconsider the use of the term “framework”. In ISDA’s view, the most important high-level objective, notably for the (non-executive) board function, is properly identified as a “coherent structure” for managing operational risk, together with “component parts,” rather than the level of detail implicit in even consideration of a “framework”.

The problem with using this term is illustrated by the fact that it appears many times throughout the paper and is elaborated at various points. If it is not deemed possible to change the term, it should in ISDA’s view at least be given a clearer description upon first mention.

As a more general point, we note the importance of reviewing both this and the Rules paper for consistency, for instance in relation to the treatment and value of insurance.

We present below the points that have struck ISDA in reviewing this second draft of ‘Sound Practices’, in the order in which they appear in the paper. (*Numbers relate to the relevant paragraph in the draft.*)

3. The use of the term “**diverse**” appears to be pejorative. This is inappropriate, given that diversification of risk is not necessarily a negative quality and more often has an advantageous impact on a firm’s risk

profile, as laid out in modern capital theory. The *management* of diverse activities does, clearly, raise certain issues, but it does not follow that diversity is inherently dangerous.

5. The reference (in the bullet points on internal and external fraud) to **acts** “of a type intended....” is somewhat unclear. ISDA’s concern is that the terms “type” and “intended” set a very broad but loose standard which does not focus sufficiently clearly on loss events. There may be an intention to address the issue of near misses, but that is a complex challenge that should be dealt with explicitly and not just in relation to these particular categories of operational risk.

It is also worth noting as a more general point that **legal risk** – which is, of course, specifically intended to be a component of the current regulatory definition of operational risk – manifests itself in many of the types of risk highlighted in the bullet point-list under paragraph 5 of the paper. The Sound Practices paper does not, however, propose any framework of standards in relation to the management of legal risk.

ISDA would be happy to develop some lines of thought on this issue.

8. Given the issues discussed in this paragraph, and specifically the “exchange of ideas” it alludes to, it would be helpful, in ISDA’s view, explicitly to recognise the distinct possibility of future revision of the 2003 Accord, after its implementation in 2006-07, and the publication at some point of a new, **‘Basel III’** Accord. It would further be helpful to provide some definition (or at least description) of the forum in which it is envisaged that the “exchange of ideas” would take place.

15. It would be preferable to indicate that the review mentioned here should be carried out as appropriate, and that not all **innovations** may prove to be relevant to every institution or even to be more generally of any lasting value.

18. This is a welcome elaboration of Principle 3, which appears to take into account vital issues of **materiality**.

19. A reference to adequate **“resources”**, including staff and management information systems, would offer a broader and less prescriptive standard, which would be preferable to the current focus purely on “staff”.

22. The meaning of the first sentence does not appear clear and could, in ISDA’s view, simply be deleted.

23. Terms such as “complexity [of the bank’s structure]” and “quality [of personnel]” are inherently **subjective**. Firms should take into account the [nature of their] structure and a range of issues concerning personnel, but it does not appear helpful to gloss these with subjective terms.

25. It should be made clear that the items enunciated here are examples of possible **techniques** rather than anything that might be considered obligatory. (In shorthand, they would be prefaced by the term “e.g.” – not “i.e.”.) It would also be helpful to acknowledge that different firms might not only emphasise some of these (and/or alternative) techniques over others, but might use a combination of techniques, and that the firm’s approach could legitimately vary over time and/or depend on the business line and/or type of operational risk in question.

It is not at all clear to ISDA why **insurance** – which is dealt with elsewhere in this paper – is not included in this list.

It would be helpful, in our view, to include a ‘health warning’ about the difficulty of translating the ‘**limits**’ concept into the operational-risk-management context. (This comment also applies to paragraph 34.)

31. For the avoidance of doubt (and assuming that the *prima facie* sense of Principle 6 is intended here), it would be best to add the word “operational” before “risks” in the first sentence.

Again, it would be appropriate (and consistent with other parts of this paper) to include insurance as a possible course of action for firms facing events whose frequency and/or severity they cannot directly control. As currently drafted, the paragraph seems to ignore the possibility of controlling the *impact* of a risk, even though a firm may not be able to ‘**control**’ the risk itself per se. In many instances (eg, natural disaster) this is precisely what a firm would logically do, as suggested in paragraph 36.

34. It should be stated explicitly that any “risk **limits or thresholds**” should be appropriate to the sub-sets of operational risk. It should also be made clear that, here (as with paragraph 25), the list is by way of illustrative example, rather than an exhaustive set of requirements.

36. It would be helpful, in relation to this discussion of risk mitigation and the contingent exposure that may arise for the firm covering its risk, to refer to the concept of **exposure at event** multiplied by probability of event.

It is also worth noting that, where firms are able to establish a credible estimate of **expected loss** and a credible means of covering that expected loss, this will contribute to the process of operational risk management.

On this latter point, we should at the same time add the following. For certain risks, it may well be cost effective not to insure, even though such insurance is readily available. For example, the premium for insuring a number of branch offices against fire could well exceed the cost of repairing any single office that is damaged. The moral is twofold. First, it should be a business decision for firms as to how much they insure. Second, assuming the estimated cost of repairs is budgeted for, this is a clear instance of where the recognition of expected loss coverage and the recognition of insurance should be treated consistently.

39. Reference to notions of materiality and appropriateness are missing from this paragraph (even though they are present in the discussion in paragraph 40). Moreover, the requirement to ensure “compliance with applicable laws” is too loosely framed, as it could be read to imply close surveillance of every action of the ‘insourcer’. The standard set here, therefore risks being so high that the potential benefits of **outsourcing** that the text rightly mentions would not, in practice, be accessible to firms.

A further possible problem with the standard as currently drafted is that the ‘insourcer’ is potentially effectively subject to banking regulatory requirements. The emphasis in relation to this standard should be focused instead on the contractual relationship between outsourcer and insourcer.

It should also be borne in mind that intra-group or internal ‘outsourcing’ of certain functions is a practical solution for many firms for certain purposes and that the sort of formal ‘service level agreement’ approach that is paraphrased here may constitute a redundant obstacle to such solutions.

In **Principle 7**, the requirement to “minimise” losses is inappropriate and inconsistent with the notion of a risk tolerance or “appetite” (as espoused in Principle 6). In some circumstances, it will be entirely appropriate for a firm to accept a certain level of potential operational loss, based on an analysis of what it

would otherwise cost to ‘minimise’ that risk. Even in the perhaps more limited context of severe business disruption, the key (and identified) factor is that of the ability to operate as a going concern. And even that ability must logically have some limit – a fact which it is essential to recognise. ISDA suggests adding wording to the effect of ‘subject to an informed decision as to risk tolerance’.

46. Under the bullet on risk mitigation, after “efforts”, it would be appropriate to add “including insurance and coverage of expected loss”.

48 & 49. Unless the purpose and form of the “**reporting mechanisms**” suggested here is more clearly spelled out and justified, this has the clear potential to introduce a burden for no well defined benefit. Nor is it clear how the proposals in these paragraphs are meant to work for an AMA firm, especially as they affect that firm’s discretion as to the (combination of) techniques it chooses to deploy. The proposals in Paragraph 49 in particular should be subject to more clearly defined limits, to obviate any temptation for supervisors to micro-manage firms at any stage.

Principle 10. Does the notion of “sufficient public **disclosure**” in effect mean what is being proposed under Pillar 3 of the new Accord? If so, this should be explicitly stated. The assumption of any “market demand for information” (in paragraph **50**) appears unrealistic at the moment and might be best reconsidered. There has, however, been a welcome shift of emphasis (apparent in paragraph **51**) from loss/capital numbers to the overall structure for managing operational risk.

Conclusion

Overall, ISDA believes this draft of ‘Sound Practices’ to be an improvement on the first. As with the first draft, the challenge is to find language that strikes the appropriate balance between flexibility for firms and a clear objective standard. The comments above are provided in the furtherance of that objective. The paper should follow through the logic of accepting in principle the supervisory recognition of insurance and promote it more positively, rather than the somewhat grudging references in the current text. It would also be helpful to ensure at every turn that firms’ freedom to choose and to develop appropriate techniques is recognised and, indeed, encouraged.

ISDA would naturally welcome the opportunity to discuss the issues raised in this submission with the Risk Management Group and does, in any case, stress ISDA’s belief in the importance of the issues and its appreciation, therefore, of the chance to comment on them.