

# ISDA

Response to Basel Committee Discussion Paper of September 2001, 'Working Paper on the Regulatory Treatment of Operational Risk'

## Introduction

The International Swaps and Derivatives Association (ISDA) very much welcomes the publication of the Paper 'Working Paper on the Regulatory Treatment of Operational Risk', published in September 2001, and appreciates the opportunity to comment on it. The Working Paper (WP) represents a significant step forward in the debate on a capital charge for operational risk and contains many elements which ISDA members consider helpful, most notably the scaling back of the proportion of capital allocated to operational risk. The current response aims mainly to highlight those areas where ISDA believes further progress can and should be made, including refinement of the 'beta' factors that will apply under The Standardised Approach (TSA) and alignment of the Advanced Measurement Approaches (AMA) with developing practice.

The International Swaps and Derivatives Association (ISDA) is the global trade association representing leading participants in the privately negotiated ('over-the-counter') derivatives and risk management industry. ISDA was chartered in 1985 and today has more than 550 member institutions from 41 countries on six continents. Information about ISDA and its activities is available on the Association's web site: [www.isda.org](http://www.isda.org).

There are a number of positive aspects to the WP. ISDA believes that, while there should be further discussion on the exact figure, allocating 12% of regulatory capital to operational risk is much more in keeping with levels of operational risk actually encountered by firms than the previously suggested 20%. By the same token, the refinement of the definition of operational risk, to remove the focus on indirect loss, better reflects risk management practice within firms and will ultimately support a more accurate (and therefore more effective) calibration of a charge. The combination of flexibility and transparency shown in relation to the AMA, including the ability to implement it business line by business line, appropriately reflects the fact that the discipline of operational risk management continues to develop (and to do so along multiple tracks). ISDA particularly welcomes the inclusion of the 'Loss Distribution Approach' within the AMA, including the potential for internal assessments of correlation, while the willingness to recognise scorecards/qualitative factors and the effects of insurance also addresses two crucial issues for ISDA members. (It is also helpful that firms may move directly from TSA to LDA.) Finally, the scaling back of the disclosure requirements is a pragmatic measure that industry participants believe is more in tune with the role of Pillar 3 of the new Accord.

## Detailed comments

In framing the final proposals, ISDA believes the Basel Committee should build on the current WP in the following ways.

### **1) Commit to a thorough, formal, scheduled review of the charge, its impact and its constituent mechanics within two years of implementation, with further periodic reviews in future.**

The paper acknowledges the difficulties of framing an effective capital treatment of operational risk, particularly while risk management practice is still evolving, and this makes it important to keep an open mind on the many and often complex aspects of the charge. One clear example of an area of potential review is the matrix of loss types given in Annex 2 of the WP. ISDA believes that it is appropriate to formally reflect this in the final proposals and that there should therefore be an explicit provision that all key elements and figures are subject to potential revision at named points in the future.

### **2) Revisit the beta and alpha factors and their potential impact.**

The paper is helpfully candid about the unreliability of the beta factors as they stand at this stage. However, ISDA members are concerned not merely that the factors be based on a more meaningful sample (and, in addition, reviewed no less than once every two years) but that they should in practice deliver the relative amount of capital

they are intended to. Analysis among ISDA's members of the impact of the beta factors quoted in the paper shows that, in a number of cases, they generate a charge well in excess of the 12% of current minimum regulatory capital targeted, up to a figure of more than double that amount. This is true, even using the relatively low median figures. While it may prove possible to mitigate this effect to some extent through further and improved data exercises, given the limited risk-sensitivity of basing capital charges on an indicator such as gross income, ISDA believes the Basel Committee should build in to the final proposals a means of ensuring that no firm's charge under TSA (or the BIA) diverges unduly from the '12% of MRC' standard which has been identified as a target. A suggested maximum divergence from this standard is 25% (ie, 3 percentage points, implying a minimum/maximum level of 9%/15% of MRC).

From ISDA's own research among 17 member firms, the (median) beta factors *on average* deliver a charge that is 3 percentage points *higher* than 12% (ie, 15%), with individual firms facing charges equal to 25% or more of current MRC. According to ISDA's research, a limit on divergence from the 12% standard would be relatively unlikely to act as a 'floor' on the capital charge for any individual firm, but would save around a third of firms from charges that were considerably (ie, 4 percentage points or more) in excess of this standard. While the standard deviation in ISDA's sample was a relatively low '6', only one third face charges below 12% (with only one below 9% and none below 8.6%), while more than half face charges above 12%, significantly so in some cases, as outlined above. In other words, there is dispersion in the figures, with the greatest divergence concentrated on the upside.

As regards the BIA, ISDA's research among 28 firms indicates that, in order to deliver the targeted level of capital, the alpha factor should be 15%, rather than the 17-20% mooted in the Working Paper.

In relation to both indicators, it is important to bear in mind that internal economic capital allocations to operational risk are not necessarily stable over time (as existing data exercises have tended to assume).

Finally, there is still debate within the industry about the consequences of using an imperfect indicator such as gross income. The potential variability of this number from one year to the next, for reasons entirely unconnected with operational loss, will tend to lead to a volatility in capital requirements which may not be fully offset by the use of multi-year rolling averages. Moreover, the relation between income and capital can vary considerably among types of firms, and the resulting crudeness of the alpha/beta factors is a phenomenon that, in ISDA's view, ought to be taken into account.

### **3) Modify the alpha/beta factors to remove the embedded size and correlation penalties.**

A fundamental issue continues to be the 'linearity' of the charge, which is not discussed in the current WP. As highlighted in the joint ISDA-LIBA-BBA paper of May 2001 (attached for ease of reference), linking the charge 1:1 to a business-size indicator unduly penalises larger firms. Empirical evidence and firms' own experience both indicate that the charge should not increase in a straight line but by a function equal at most to the power of 0.5<sup>1</sup>.

A further issue with the beta factors is that they make no allowance for correlation/diversification effects, which will be considerable across a firm incorporating more than one of the 8 business lines identified in the paper. To remedy this, a conservative 'placeholder' assumption as to correlation could be included, pending fuller data and subject to review.

### **4) Reconsider the 'floor' in the AMA.**

ISDA welcomes the commitment to review the floor set at 75% of a firm's charge under TSA. However, while ISDA understands the interest in a mechanism such as a floor, it believes that the floor is not strictly justified in the first place, given the extensive and detailed criteria that have to be met before a firm can qualify for AMA, and which provide a notably high level of comfort with regards to a firm's suitability for AMA. A floor tends to undermine the risk-sensitivity of the AMA, and therefore some of the incentive for a firm to move to it. (It also carries over the 'linearity' effect from the BIA/TSA.) As such, the floor is inconsistent with the primary stated objective of the current review of the 1988 Accord, namely a more risk-sensitive capital framework.

While ISDA's preference is that the Basel Committee simply refrain from imposing the floor, it has considered alternatives which, though inferior in its opinion, would mitigate at least some of the problems that the floor entails. One would be to base the floor on the number used for industry-wide calibration, rather than on individual firms' charges under TSA. In other words, the floor could be set at 9% of a firm's current MRC (ie, 75% of MRC\*0.12) rather than a potentially much higher number derived from a TSA charge [see point 2, above]. Of

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<sup>1</sup> A square root function, ie the power of 0.5, is actually conservative, compared with empirical evidence regarding severity of loss which supports a function to the power of 0.25.

the alternatives to simply removing the floor, this would be ISDA's preference (albeit it too would require some form of review in the future, in order to ensure that 9% of MRC under the 1988 rules remained an appropriate level). Another, less favoured approach would be to set the floor at a lower level relative to the TSA charge, namely 50%.

Any floor should not, in ISDA's opinion, act as a limit on the applicability of insurance or qualitative adjustments, again in the interests of risk sensitivity.

#### **5) Revise the business-line/event-type matrix.**

Ideally, this matrix should be a) simplified and b) specifically included as an item for review under the process suggested by ISDA in point 1 of this comment paper. ISDA members propose to undertake a project to rework this matrix to deal with potential inconsistencies and overlap as to risk categorisation. In the meantime, to reduce i) the scope for this type of problem and ii) the major (and, ISDA would argue, irrelevant) burden of 'mapping' internal data to this matrix, it is desirable to simplify it. (This could well have the additional effect in the longer run of supporting better calibrated beta factors. See also our comments below on holding period/confidence level.)

#### **6) Widen the scope for application of insurance and qualitative factors.**

The inclusion of insurance and qualitative factors is most welcome, as both play a meaningful role in relation to the management of operational risk. However, it is inconsistent and unnecessary to limit their applicability to AMA. Both forms of adjustment of the capital charge are proposed to be subject to specific qualifying criteria (rather than being dependent solely on the general AMA qualifying criteria) which will provide significant comfort as to their robustness. And both are either a form of risk modification (in the case of insurance) or reflective of one (qualitative adjustment), risk modification rightly being recognised elsewhere in the proposed new Accord (viz, credit risk mitigation, even in relation to simpler approaches for credit risk). If the objective in limiting the applicability of insurance/qualitative factors is to preserve the incentive for firms to move to the AMA, then this is better and more appropriately achieved by other means, notably through the removal of the floor. Furthermore, ISDA believes it is likely to slow the development of operational risk management if recognition of insurance and qualitative factors is artificially limited by the use of a floor.

#### **7) Maintain dialogue.**

ISDA believes that dialogue between regulators and industry has been beneficial in moving forward on the treatment of operational risk and that it is appropriate for this to continue. This is relevant to all the issues enumerated above, but also to following topics, where ISDA stands ready to undertake further work:

- i) The holding period and/or confidence level applicable to AMA.** Debate continues within the industry as to the appropriate holding period and confidence level. The latter is set at a surprisingly high level, 99.9% equating to a targeted level of creditworthiness of 'A' on the part of supervised firms, whereas a level of 'BBB' would accommodate a default probability of around twice that level while remaining within the bounds of investment grade. While ISDA would not necessarily argue that both the holding period *and* confidence level should be reduced, in combination they seem likely to lead to capital requirements that would capture more of the "tail" of operational risk than firms would typically target in prudent risk management programmes. Moreover, if this was the confidence level targeted in each cell of a business-line/risk-type matrix, and the capital from each cell of the matrix was added together, the overall confidence level would in reality be much higher than 99.9%. This would be excessive as a risk measure, and would in effect discourage granularity of risk measurement on the part of firms. ISDA would, therefore, welcome further dialogue on this issue.
- ii) Models-validation criteria.** In developing or refining models, it is important for firms to know what validation standards those models will be required to meet. These criteria should be comparable with the criteria applied in relation to models for credit and market risk.
- iii) AMA methodologies.** To allow for that fact the operational risk management practice continues to develop, ISDA believes that the AMA should potentially be open to other techniques and not necessarily limited to those enumerated in the Working Paper. Nor should firms be obliged to move to the AMA. In principle, ISDA welcomes the inclusion of scorecards as a potential AMA. The

application in practice of this methodology, however, would clearly benefit from further study and discussion so that it may be satisfactorily incorporated into the capital framework.

- iv) **Loss-data-collection thresholds.** Further consideration should be given to these, as they have a material impact on the formulation of databases and the related IT and internal control structure. In particular, care will be needed to set appropriate minimum standards. Furthermore, it is appropriate to calculate losses net of recoveries. Also, ISDA believes further dialogue is necessary in relation to the use of external data, which may well be useful but requires great care when it is blended with internal data.
- v) **Outsourcing.** ISDA members are concerned that this important phenomenon is not dealt with in the proposed rules and that, subject to the satisfaction of appropriate criteria, the transfer by outsourcing of the risk of direct loss should be recognised. The types of transfer and its completeness are issues that require discussion.
- vi) **Expected loss.** The industry continues to believe that it is appropriate to factor in those cases where routine operational losses are adequately covered by margins, loss reserves, future income and so on.
- vii) **The definition of “gross income”.** For firms whose charge is linked to gross income, the latter should in principle be calculated according to existing local rules, rather than creating a new reporting system which could be burdensome. To ensure that the charge remains comparable across jurisdictions, it will be necessary to compare and contrast local GAAP.

### **Conclusion**

In conclusion, ISDA believes that the current Working Paper represents a helpful foundation for the final proposals. At the same time, it remains true that industry practice is developing, making future dialogue a vital part of an effective capital framework for operational risk. Furthermore, ISDA believes that the issues covered in the current response will require discussion before proposals can be finalised.

ISDA is grateful to the Basel Committee for the opportunity to comment and is at the disposal of the Committee and the Risk Management Group in discussing any of the issues raised in this paper.