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THE INSTITUTE OF OPERATIONAL RISK

Pillar 2 Capital Team
Prudential Regulation Authority (PRA)
20 Moorgate
London
EC2R 6DA

12th October 2017

Dear Sirs,

Re: Consultation Paper CP12/17 Pillar 2A capital requirements and disclosure

This letter is the response from the Institute of Operational Risk (IOR)[1] to the PRA's Consultation Paper CP12/17.

The IOR welcomes the PRA's revised disclosure proposals and their stated purpose of "*…bringing greater clarity, consistency and transparency to the PRA's capital setting approach*." The IOR has, however, two recommended enhancements intended to:

1. Reduce the inconsistencies between the disclosed capital requirements of firms variously adopting either the Advanced Measurement Approach (AMA) or The Standardised Approach (TSA); and

2. Remove the inconsistencies between the disclosure of Credit Risk losses (i.e. impairment charges) and Operational Risk (Op Risk) losses.

1. Reducing the inconsistencies between disclosed Op Risk capital requirements

The PRA's proposals restate the purpose of Pillar 2A capital i.e. it "*protects firms against risks that are not, or not fully, captured under Pillar 1*". This is clearly especially relevant to Op Risk capital requirements, as the Basel Committee on Banking Supervision (the Basel Committee) has previously observed that the "*simple approaches for Operational Risk – the Basic*

[1] The IOR is an international professional members' body with a mission to promote and develop the discipline of Op Risk management. The IOR currently has more than 600 members across seven Chapters: England & Wales, Scotland, Ireland, the Netherlands, Germany, Nigeria and Hong Kong.

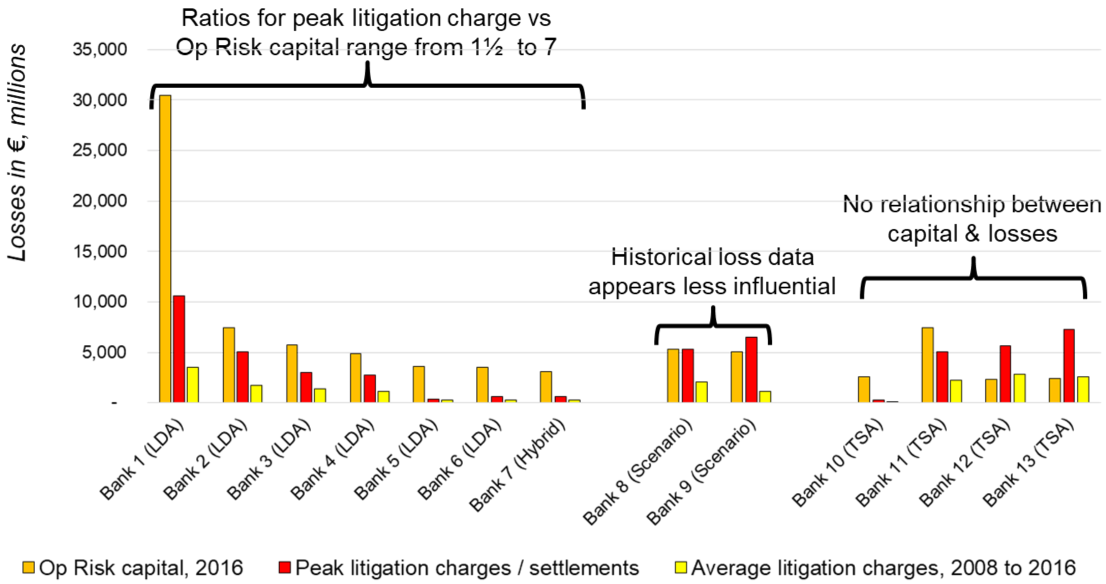
Indicator Approach (BIA) and the Standardised Approach (TSA)…do not correctly estimate the Operational Risk capital requirements of a wide spectrum of banks."[2]

Additionally, the Basel Committee has also previously noted that there are issues with AMA i.e. "*…the lack of comparability arising from a wide range of internal modelling practices have exacerbated variability in risk-weighted asset calculations, and have eroded confidence in risk-weighted capital ratios*."[3]

These issues are illustrated in Figure 1, which is an analysis for 13 large US, Swiss, European and UK banks of:

- Pillar 1 Op Risk capital requirements for 2016;
- The peak annual litigation charges / settlements[4] between 2008 and 2016; and
- Average annual litigation charges / settlements for 2008 to 2016.

Figure 1: Illustration of the issues with the comparability of Pillar 1 Op Risk capital



Three observations can be made from this analysis:

1. For the seven AMA banks (#1 to 7) that use either a Loss Distribution Approach or a hybrid approach, their 2016 Pillar 1 Op Risk capital requirements range between 1½ to 7 times greater than their largest annual litigation charges / settlements between 2008 and 2016. The larger multiples may reflect the influence scenario analysis as an overlay;

2. For the two AMA banks (#8 & 9) that calculate their Pillar 1 Op Risk capital requirement using predominantly scenario based approaches, their largest annual litigation charges / settlements for 2008 to 2016, actually exceed their 2016 capital requirements; and finally

[2] Basel Committee Consultative Document: "*Operational Risk – Revisions to the simpler approaches*", October, 2014.
[3] Basel Committee Consultative Document: "*Standardised Measurement Approach for Operational Risk*", March, 2016.
[4] Most banks do not disclose their total Op Risk losses, however, the banks sampled do disclose their annual litigation charges / settlements, which will represent a significant proportion of their total Op Risk losses.

3. For the four TSA banks (#10 to 13), there is no relationship between their Pillar 1 Op Risk capital requirements and their litigation losses for 2008 to 2016. This consistent with the Basel Committee's observations from October 2014.

Recommendation 1: Pillar 2A requirements for Op Risk should be separately disclosed for both AMA and Standardised Approach firms for which the PRA is the home regulator, in order to achieve greater *"…consistency and transparency…"* between both AMA and TSA firms and also between different AMA approaches.

2. Removing the inconsistencies between the disclosure of Credit Risk and Op Risk losses

Accounting conventions differ regarding disclosure of losses arising from the three key risk categories i.e.:

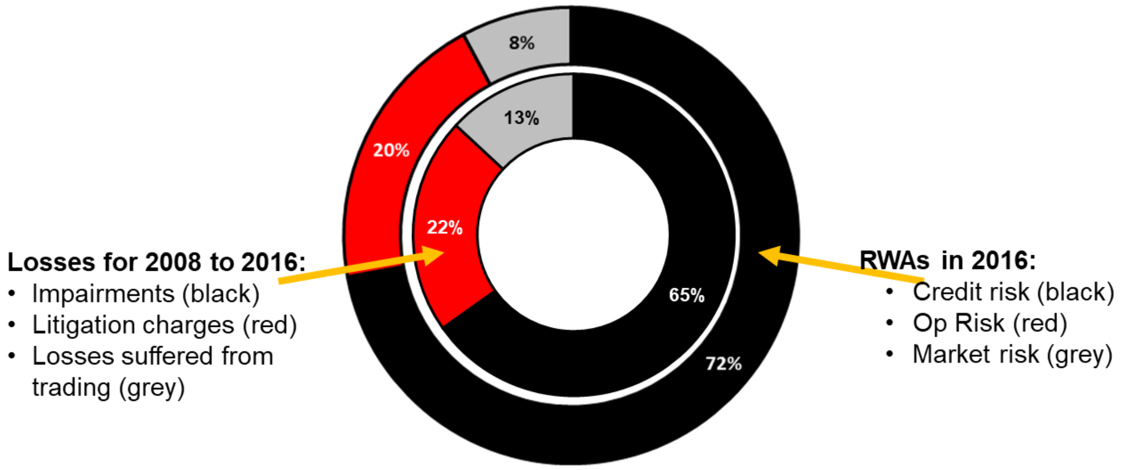
i. Credit Risk: Credit impairment charges are consistently disclosed;

ii. Market Risk: Negative trading income is also usually disclosed as part of an analysis of revenues; and

iii. Op Risk: Whilst litigation charges / settlements are often included in notes to the accounts, total Op Risk losses are not commonly disclosed.

This seems inappropriate given the significance of Op Risk i.e. for the nine AMA firms, Op Risk was the 2nd largest component of their Pillar 1 capital in 2016. As these nine banks disclose their annual litigation charges / settlements it is possible to see that there is a close relationship between Pillar 1 capital across all three risk categories and the losses suffered by these banks during the period for 2008 to 2016. This is illustrated in Figure 2.

Figure 2: Comparison of RWAs for nine AMA firms in 2016 with losses across all three risk categories from 2008 to 2016



Additionally, where firms have disclosed their litigation charges / settlements it provides greater transparency and understanding of the profile of their losses across all three risk categories over the course of the Financial Crisis.

Figure 3 shows how losses arising from the different risk categories came in sequential and overlapping waves, with peaks for the period since 2008 respectively occurring in:

- 2008 for Market Risk;
- 2009 for Credit Risk; and
- 2013 for Op Risk, which goes on to surpass Credit Risk in 2014 to become the most important risk category in terms of losses.

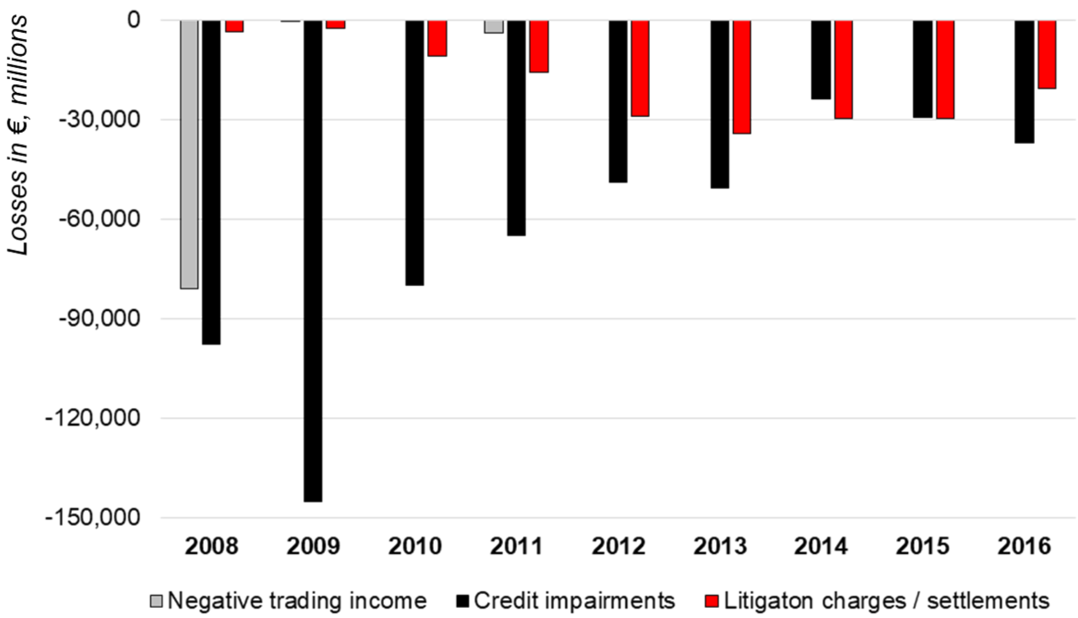
This pattern of losses for Op Risk may reflect:

- Lags in the conversion of financial losses suffered by investors and customers into litigation against the firms that sold them the underlying products that fell in value after the Financial Crisis (e.g. the mis-sale of Mortgage Backed Securities and interest rate derivatives);

- Lags in the resolution of regulatory misconduct (and subsequent civil claims) that occurred pre-2007 but was only exposed during the Financial Crisis (e.g. LIBOR rigging); and

- Lags in the discovery and resolution of misconduct by staff in response to the Financial Crisis, e.g. inappropriate foreclosure and occurrences of inaccurate financial disclosure.

Figure 3: Profile of trading losses (Market Risk), impairments (Credit Risk) and litigation charges (Op Risk) for the 13 sampled banks



Recommendation 2: Pillar 3 disclosure for Op Risk should be further expanded to include total Op Risk losses, split by Basel categories, as has previously been suggested by the Basel Committee[5] in a Consultative Document, for firms for which the PRA is the home regulator. This should deliver both greater consistency with Market and Credit Risk and transparency of the interrelationships between these three key risk categories.

Next steps

The Institute of Operational Risk would welcome the opportunity to participate in any further discussion or consultation on these proposals.

Yours faithfully,

George Clark

Chair of the Council of the
Institute of Operational Risk

[5] Basel Committee Consultative Document: "*Pillar 3 disclosure requirements – consolidated and enhanced framework*", March, 2016.