Operational Riskdata
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April 3, 2009

Mr Arnoud Vossen,
Secretary General,
Secretariat for the Committee of European Banking Supervisors,
Level 18,
Tower 42,
25 Old Broad Street,
London,
EC2N 1HQ

Dear Mr Vosser,

Re: CEBS Consultative Paper 21 - **Compendium of Supplementary Guidelines on implementation issues of operational risk**

The Members of the Operational Riskdata eXchange Association ("ORX") welcome the opportunity to respond to the consultative paper issued by CEBS on December 19, a "Compendium of Supplementary Guidelines on implementation issues of operational risk". ORX provides, below, comments only on Section C: "Guidelines on the scope of operational risk and operational risk loss". The comments reflect the collective views of ORX and not necessarily those of any individual member firms or their management.

ORX is encouraged by this supervisory initiative on the scope and categorisation of operational risk events. ORX, as an organisation dedicated to the delivery and reporting of operational risk loss events, hopes its views will be of great value to CEBS. ORX would welcome the opportunity to discuss with CEBS the comments below or other aspects promoting the consistent collection and categorisation of operational risk loss data.

The comments below are provided in the following order:

- An overview of ORX
- Recommendations from ORX
- Annex -Detailed commentary upon Section C of the Consultative Paper

An Overview of ORX

ORX is incorporated in Switzerland as a “not for profit” organisation that is owned by its Members. At the time of writing ORX has 52 members from 18 countries.

ORX was established to enable its members to deliver and receive high quality operational risk loss data on an anonymised basis. Consistency in categorisation is an aspect of quality to which ORX devotes considerable effort.

In support of promoting consistency of the collection and categorisation of operational risk event data, ORX established the Definitions Working Group (“DWG”). The DWG meets on a regular basis to discuss data collection and categorisation issues identified by members. Some of these same issues are also raised in the Consultative Paper from CEBS.

DWG members frequently conclude that whether an event is operational risk or not can depend upon relatively small details. In addition, the amount of information about an event can change over time and may result in a re-classification within operational risk or it may even be reclassified as not being an operational risk. In most situations because it is only the institution experiencing the event that has sufficient detail to classify the event it is very difficult for an independent third party to validate.

The DWG is also responsible for setting ORX’s Operational Risk Reporting Standards that detail scope, categories and definitions to be used by all members. The standards promote consistency and act as a reference document for ORX members and non-members alike. The standards are subject to periodic review and updating as practices evolve and mature. As such, these standards are due for re-drafting and re-issuance this year.

As ORX members have made increasing use of the loss data for deeper analysis, additional hierarchies to attach to event data have been explored. The additional categories being contemplated include Products and Processes to increase the “richness” of the data. For significant operational risk events, the members have asked for additional transparency and steps to promote consistency in categorisation. These large events are of significant interest to members as they may influence scenario creation, benchmarking, and capital calculations.

For the most recent data delivery, occurring in February 2009, members reported in excess of 110,000 losses representing a total operational risk loss of over €37 Billion. For some members the data includes events reflected in their accounts going back to 2002.

Recommendations from ORX

ORX is encouraged by the supervisory initiative to promote improved understanding and consistency in the categorisation of operational risk losses. ORX is gratified to see that the issues identified by the supervisors are similar to the ones being raised by Members. In only a small minority of issues do the recommended treatments differ. We would emphasise the following points:

1. **A principles based approach**

For the majority of operational risk events, classification is straightforward; these are events that can easily be aligned with the existing categories and descriptions. However, for infrequent complex events being able to refer to principles is a good starting point.

From experience of discussions within ORX over event categorisation there can be a change in categorisation due to a small change in detail. As a result, the preference of ORX is to start from definitions then principles and work from the foundation that they provide.

2. **Recognize losses only once**

From the definition of an operational risk event and any losses arising, it is important that losses are not represented in capital calculations multiple times. This should be stated as a principle. In some instances the losses arising from operational risk events are known to be captured in credit risk capital calculations. Some of the larger operational risk events, such as Enron are reflected in the credit risk capital calculations. Other less extreme examples, such as documentation around collateral, may also be reflected in the credit risk capital.

3. **Guidelines should reflect good practice and support value**

The experience of ORX shows that firms will extend the scope of data collected based upon the utility of the additional information obtained. Utility is best supported by clear, unambiguous and practical standards. We are concerned that “Near Misses” and “Pending Losses” do not meet this standard and are not industry practice.

It is proposed that CEBS only recommend that internal policies of firms explicitly address aspects such as the treatment of “Near Misses” and “Pending Losses” rather than impose practices upon the industry that may not be standard or even leading. If firms find value in the collection of “Near Misses” and “Pending Losses”, over and above the cost of collection, then this will be evident from their internal policies.

ORX appreciates the opportunity to support CEBS and the wider regulatory community in promoting consistency in the categorisation of operational risk losses. If you have any queries relating to this letter or the detailed Annex please contact Simon Wills (simon.wills@orx.org).

Yours Sincerely,

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Chairman,
Operational Riskdata eXchange Association,
Zurich

Simon Wills
Executive Director,
Operational Riskdata eXchange Association ,
Zurich

Annex

CEBS Consultative Paper 21
Compendium of Supplementary Guidelines on implementation issues of operational risk
Section C **-** Guidelines on the scope of operational risk and operational risk loss

A Introduction

This Annex contains detailed comments on Section C ("Guidelines on the scope of operational risk and operational risk loss") of the CEBS consultative paper. The reference document used for generating these comments are the ORX Operational Risk Reporting Standards (2007) published by ORX and any subsequent related discussions that have taken place within the ORX Definitions Working Group.

The original regulatory guidance on the classification and categorisation of operational risk losses was published by Basel in 2004 and by EU Directive in 2006. Nevertheless, neither ORX nor the regulatory community sees the need to propose major changes to categories. This will be encouraging for firms.

However, with every classification system there is a need to review and provide clarification as experience accumulates. From the ORX perspective a common type of discussion relates to boundaries between categories. Any clarifications or amendments to loss classifications have to be crafted in such a way that promotes their use, not only by specialists, but also by the people actually allocating categories to individual losses as they populate databases in firms.

The experience of ORX has shown that only a very small percentage of the number of losses raise concerns in the ORX Definitions Working Group (DWG) over their categorisation.

B Mechanism by which clarification is provided

It is appreciated that one of the factors giving rise to the supervisory review of loss event categorisation has been the recent Loss Data Collection Exercise. However, a period of 2-3 years between such categorisation reviews may be too long.

ORX has adopted the approach of on-going incremental reviews. This also provides the added benefit of topicality.

As mentioned above, ORX is planning to publish revised Operational Risk Reporting Standards. These revised standards will include the outcomes of discussions held over the past 12-18 months within the DWG. Consideration is being given to a mechanism to publish or notify others of the outcome of DWG discussions on categorisation. A key factor to getting a good result is the engagement of individuals with practical experience in this field and being able to access their knowledge of other internal reporting and accounting practices.

C Implementation

If the results of the consultation process amend the details of reports to regulators then there are arguments for the consistent adoption of any revisions across the EU and internationally. A consistent adoption would reduce costs for the regulators and firms as well as reducing uncertainty over which categories are in use.

Annex

D Definitions & Terms

The discussion below relates mainly to Section 3 – The “scope of operational risk” and Section 4 – The scope of “operational risk loss”. ORX fully supports the objective for the unambiguous and consistent classification of operational risk losses.

1 A principles based approach

The experience of ORX has shown that the definition of operational risk is a good starting point for a number of discussions around boundaries with Market Risk, Credit Risk and Business/Strategic Risk.

For Business/Strategic Risk there is no Pillar I capital calculation from which to derive a definition. As a result, ORX uses the following text to support discussion:

> *Losses arising from flawed strategic or discretionary processes are not recordable in the ORX database. Such losses are considered the result of business-strategic risk. Project risk is included in the business-strategic risk category.*

The boundary between OR and Business/Strategic risks can be seen in Section 3.1 paragraph 16 C where reference is made to the “wrong selection of a model, made outside a defined business process/formalised procedure and lacking a formalised conscious risk-taking”. It is assumed that the definition and scope of this internal “procedure and formalised conscious risk taking” is Business Risk. An illustration of such a procedure would be a firm seeking legal advice on a documentation or contractual issue. The act of requesting advice and whether to follow it is Business/Strategic Risk.

The examples relating to model risk (paragraph 17) refer to “a failure in updating prices or to wrong attribution of its parameters”. It was not clear whether the determination of “wrong” was made in reference to a predetermined business process not being followed or a comparison between ex ante and ex post prices. Let us assume that a firm uses a default rate of X in a model, following prescribed business processes. If subsequent experience shows that the actual default rate is Y then X is still the correct value at the time that the model was used. However, if the business process provided a value of Y and this was replaced by X, outside the established business process, then an operational risk event has occurred.

For the example on “compensation paid to employees and refunds to customers before they can lodge a complaint.....” in paragraph 18, a consistent industry view has not yet emerged as to whether this is Business/Strategic or Operational Risk. At this time it is recommended that the industry devise its own policies or guidelines on allocating such events between the two risk types. Is it a Business/Strategic or Reputational Risk management decision to pay the compensation before it is required? Has an operational risk actually event occurred? A starting point would be the definition of an Operational Risk Event.

The expectation is that the end result of this consultation process will be guidance in the form of the principles and examples provided in this section. With this objective the drafting and terminology becomes very important. The experience of the ORX Definitions Working Group is that event classification can be dependent upon small details.

For the majority of events their classification is straightforward, these are events that can easily be aligned with categories and descriptions. However, for infrequent complex events being able to refer to principles is a good starting point. These principles can then be supplemented by examples.

2 Capture losses only once

Section 4 discusses "the scope of operational risk loss" and the statement or a principle on operational risk loss would support the examples provided in the table as part of paragraph 20. The description used by ORX is:

> *An operational risk loss is a negative impact on the earnings or equity value of the firm due to an operational risk event.*

It is appreciated that CEBS, like ORX, draws a distinction between operational risk events and operational risk losses. It is recommended that this is reinforced by the provision of principles or definitions of operational risk events and losses.

There should also be a principle that losses are not represented in capital calculations multiple times. This situation may arise where there is lack of clarity over whether a loss is reflected in the Operational or Credit Risk capital calculations. In some instances the losses arising from operational risk events are known to be captured in Credit Risk capital calculations. Some of the larger operational risk events, such as Enron are reflected in the Credit Risk capital calculations. Other less extreme examples, such as documentation around collateral, may also be reflected in the Credit Risk capital.

3 Guidelines should reflect good practice and support value

The experience of ORX shows that firms will extend the scope of data categorisation based upon the utility of the additional information obtained. Utility is best supported by clear, unambiguous and practical standards. We are concerned that "Near Misses" and "Pending Losses" do not meet this standard and are not industry practice.

In paragraph 22 there is a discussion of "pending losses". It is assumed that this category excludes actual or potential operational risk events and losses where a legal process, such as litigation, is involved. To include events or losses that are waiting for the outcome of legal processes, even if recognised in the form of provisions, could give rise to undesirable unintended consequences.

For "pending losses" an approach to estimating extent of the risk, in the form of the size of loss (as opposed to exposure) would be to create a scenario to reflect the risk of the situation However, scenarios used for capital calculation purposes take time to create and quality assure. Whether to create a specific scenario should be a decision made by the firm. Creating a scenario is separate from decisions on provisioning. Making provisions creates concerns about undesirable unintended consequences that can materialise as a result. The existing accounting guidance on provisioning should be adequate.

In paragraph 23 there is a detailed discussion on a number of impacts of operational risk events included in the table that is part of paragraph 20, in particular "near misses", "operational risk profits/gains" and "opportunity costs/lost revenues". While these categories of impacts may contain information for operational risk management there are some concerns. One of these concerns relates to the clarity of definition or description. For example, in paragraph 21 reference is made to reporting charges to the P&L, and yet in paragraph 23 “timing losses” can be excluded, but most of these flow through the P&L.

It is not clear that the identification and collection of these impacts have yet reached the maturity that could be described as sound practice. In addition, there is some concern as to how different regulators will interpret “sound practices”. Nevertheless, firms might be expected to comment, in guidelines or policies, upon the collection of these particular impacts.

With regard to “timing impacts”, also known as timing losses, this is a topic where the wording will be heavily scrutinised. It is fully appreciated that a key feature of the definition of a timing loss is the temporary nature of the impact upon the firms’ P&L. As a result, ORX recommends that timing losses should be excluded from the scope of operational risk losses captured for measurement purposes.

For reference the ORX description of a timing impact or timing loss is:

> *A timing impact is a temporary distortion to the aggregate P&L of a firm in a particular reporting period that can be fully corrected when later discovered. It results in P&L being shifted from one period to another.*

In summary it is proposed that CEBS only recommend that internal policies of firms explicitly address aspects such as the treatment of “Timing Losses”, “Near Misses” and “Pending Losses” rather than impose practices upon the industry that may not be standard or even leading. If firms find value in the collection of “Timing Losses”, “Near Misses” and “Pending Losses”, over and above the cost of collection, then this will be evident from their internal policies.