A response to the

The PRA's CP16/22

Chapter 8

Operational Risk

Introduction

UK Finance is the collective voice for the banking and finance industry. Representing more than 250 firms, we act to enhance competitiveness, support customers, and facilitate innovation.

We are pleased to respond to chapter 8 of the PRA's CP16/22 which proposes changes to the PRA's approach to proposals to implementing the Basel 3.1 standards for operational risk.

Recommendations

Recommendation 8.1

- The PRA should eliminate the disclosure and reporting requirements for historic operational losses.

Rationale

We welcome the PRA's proposal to exercise its national discretion in the Basel 3.1 standards to set the ILM equal to 1. We therefore question the need to still collect a firm's 10-year history of operational losses especially, in light of the more sophisticated 5-year loss approach in the PRA's approach to Pillar 2.

Recommendation 8.2

- Business indictor components should be mapped to other regulatory reporting requirements.

Rationale

Members would welcome PRA mapping business indicator components to other regulatory reporting such as FINREP even if comprehensive mapping is not possible. We do appreciate the flexibility afforded on basis of calculating the business indicator components, particularly for the annual calculation.

Recommendation 8.3

- The PRA should clarify the likely timeline of the planned Pillar 2 review.

Rationale

We would welcome the PRA set out in the policy statement how and when its Pillar 2 review would be completed, as the timing could have an impact on firms' capital planning as well as Basel 3.1 implementation.

Recommendation 8.4

- The PRA should set out its 'Day 1' starting point for operational risk for Simpler-regime firms.

Rationale

Given that the capital framework for simpler firms is not expected until H1 2024, can the PRA set out its starting point for operational risk in the policy statement, similar to it starting point for credit risk. Given the current uncertainty it is difficult for those firms that may fall within the simpler regime to evaluate their options.

Recommendation 8.5

- The PRA should engage with other members of the Basel Committee to address operational risk shortcomings in the Basel framework.

Rationale

As part of its ongoing engagement the PRA should encourage the Basel Committee to address some of the shortcomings in the Basel Pillar 1 framework, such as those relating to lack of recognition of operational risk insurance and issues for groups with a subsidiary-based business model where group-level operational risk capital requirements can be significantly higher than the sum of capital requirements across subsidiaries.

PRA questions and rationale for recommendations

Q47: Do you have any comments on the PRA's proposed implementation of the standardised approach (SA) in the Basel 3.1 standards for operational risk capital requirements?

Simpler firms – TCR or Basel 3.1? The PRA has proposed that firms wishing to opt into the 'simpler' regime can remain on the current regime – transitional capital regime (TCR) – until the PRA finalises the simpler regime capital framework. In this regard, the PRA has indicated in this consultation that the proposals for standardised credit risk proposals are likely to be a good starting point for the simpler regime credit risk framework. It is not clear if the PRA is intending a similar approach for Operational risk as the consultation is silent on this. Given this uncertainty it is difficult for those firms that may fall within the simpler regime to evaluate their options. This has unintended consequences for these firms' capital planning. It is also not clear if firms can 'pick and choose' between TCR and CP 16/22 proposals for different Pillar 1 risks.

Business Indicator – Data Sources: Our understanding of the PRA's proposed rules in Chapter 8 and Chapter 12 (reporting) is that the Business Indicator sub-components can be calculated using year-end results which need not be audited. This retains the flexibility that is currently available under CRR, which requires 'where audited figures are not available, institutions may use business estimates'. Members generally support the retaining of this level of flexibility.

Business Indicator – mapping: We also understand from Chapter 12 that firms reporting under FINREP may use the same data definitions or the corresponding item reported in FINREP. Members support this approach; however, it would ease implementation (especially for smaller firms) if the PRA could describe appropriate mappings from Business Indicator sub-components to FINREP where such correspondence exists. We understand it may not be possible to create such mappings for all Business Indicator sub-components, [such as relating trading book and banking book analyses] but covering a significant proportion would support firms' implementation.

Business Indicator – Exclusion of divested activities: Under paragraph 8.17 of the consultation paper the PRA proposes to implement an approval process where firms can request supervisory approval to exclude divested activities from the calculation of the BI, in line with Basel 3.1. However, in paragraph 5.5 (2) of Annex K, firms can apply to the PRA for permission to exclude business acquisitions or mergers, which in our view does not include divested activities. We would suggest that divested activities are specifically referred to in this paragraph.

Interactions between Pillar 1 and Pillar 2 capital: could the PRA set out in the policy statement how and when its Pillar 2 review would be completed, as the timing could have an impact on firms' capital planning as well as Basel 3.1 implementation. Most firms' reporting is based 31 December position however the new capital requirements are proposed to come into from 1 January 2025, so it is unclear how this will operate in practice. Possible options are:

- An interim Pillar 2 review is carried out in 2024 based on 31 December 2023 position or nearest year end position, reflecting Basel 3.1 on a best endeavours basis, and this should be reflected as Pillar 2 until next Pillar 2 review cycle in 2026 or later.
- The Pillar 2 review is carried out on first year end position after Basel 3.1 implementation, for example review in 2026 based on 31 December 2025 position.

Q48: Do you support the PRA's proposal to set the internal loss multiplier (ILM) equal to 1?

We welcome the PRA's proposal to exercise its national discretion in the Basel 3.1 standards to set the ILM equal to 1. We also welcome the PRA:

- intending to continue to apply supervisory judgement regarding the relevance of past losses to future operational risk by the Pillar 2A framework
- not intending to require firms to calculate capital requirements for the same risk under both the Pillar 1 and Pillar 2 frameworks
- proposing to maintain the requirements in relation to policies and processes

Operational loss time series disclosure and reporting

Given the PRA's view on the merits of operational risk losses as noted in Chapter 8 (extracts below), we challenge the need for operational risk loss event Pillar 3 disclosure and COREP reporting. Should the PRA conclude that operational loss information is needed then we suggest the PRA use the operational loss events monitored and assessed as part of its "*sophisticated Pillar 2 assessment process".* If for some reason, such information is still required we suggest*:*

- allocation basis for operational risk loss events for COREP should be aligned to the allocation basis used for Pillar 2 / STDF, to ensure consistency and minimise operational burden.
- frequency of reporting be annual, given the lack of correlation to capital measure
- reporting for newer firms is shortened as the business model/strategy and operating activities may have changed significantly over the prior years and consistent data may not exist in most cases
- disclosure requirements are eliminated as such disclosure may create misleading market perception.

Extracts from Chapter 8 of CP 16/22:

"The PRA considers that the information value of operational risk losses generally diminishes over time as business models and lending activities change. The SA's use of a 10-year window of unweighted past losses in the ILM could result in it being inappropriately affected by large historical operational risk losses near the start of the 10-year period that might be weak predictors of future losses."

Extract of rules for operational loss allocation bases:

- *CP 16/22 Appendix 4 (Draft PRA Rulebook) Annex K para 7.2.6(c) states: "it must allocate losses caused by a common operational risk event, or by related operational risk events over time but posted to the* *accounts over several years, to the corresponding years of the loss database in line with their accounting treatment."*

- *FSA form 073 (for Pillar 2 data collection) states: "Operational risk losses caused by a common operational risk event or by multiple events linked to a root event must be grouped and entered into the dataset as a single loss."*

Other comments - Basel Rules shortcomings

The Basel 3.1 Operational Risk standard shortcomings – as the PRA's proposed capital requirements rules are in line with those of the Basel Committee these shortcomings also apply. Whilst we understand that the Basel Committee have not a defined mechanisms to adjust Pillar 1 capital requirements to address these, we would suggest that these areas are considered by the PRA in the assessment of a firm's total capital requirements for Operational Risk, which would enable adjustments to be made through Pillar 2.

Operational Risk Insurance: The use of insurance for operational risk is an effective approach to manage risk exposure and can transfer risks outside of the Banking sector. We note that the loss data collection requirements outlined by the PRA in the CP require firms to use 'losses net of recoveries (including insurance recoveries)', however the calculation of capital requirements using the Business Indicator Component does not reflect any risk mitigation from insurance against future operational risk losses.

Banking Group Issues

Penalising higher income groups: The BIC assumes that the size of an entity is a good indicator of the entity's operational risk profile and penalises banks with higher income by applying a higher marginal coefficient to their capital calculation. For banking groups with a subsidiary based business model, the BIC and operational risk capital at a consolidated level is likely to be greater than the sum of the BIC and capital requirement across subsidiaries due to the application of a higher marginal coefficient (which is not applied for individual subsidiaries). This effect may also provide barriers to the consolidation of banks within the UK - newly combined banking groups will not only be subject to potential increases in capital requirements from G-SII or O-SII buffers but could also be subject to an additionally penalty from increases to the BIC.

'Margin cap': The calculation for interest, leases, and dividend component (ILDC) imposes an effective 'margin cap' which reduces capital requirements for banks based in high-margin jurisdictions. However, for a UK banking group with subsidiaries in such jurisdictions, when calculating the consolidated Business Indicator, the margin will be 'averaged' across the entire group and so the benefit of the cap is unlikely to apply. This could result in operational risk capital at a consolidated level being greater than the sum of the capital requirements across subsidiaries.

The example below illustrates this, considering a Banking Group comprised of two subsidiaries, with one a low margin jurisdiction (Subsidiary 1, with Net Interest Margin rate of 1.5%) and one in a high margin jurisdiction (Subsidiary 2, with a Net Interest Margin Rate of 3%). For Subsidiary 1 in isolation, the Net Interest Margin (Column A) is not reduced by the 2.25% * Interest Earning Asset 'cap' (Column B) in contrast to Subsidiary 2.

When considering the consolidated Banking Group position, the Net Interest Margin is not reduced by the ‘cap’, and ends up being greater than the sum of the ILDC Sub-Components for Subsidiary 1 and Subsidiary 2.

			Column A	Column B		
	Average Interest Earning Assets	% Net Interest Margin rate	Net Interest Margin	2.25% Interest Earning Assets	ILDC Sub-Component	*Sum of Subsidiaries*
Subsidiary 1	750	1.50%	11.25	16.875	11.25	*16.875*
Subsidiary 2	250	3%	7.5	5.625	5.625	
Banking Group			18.75	22.5	18.75	

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