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Dear Sirs and Madams:

The banking agencies on May 12 released a summary of the information collected in their 2004 Loss Data Collection Exercise (LDCE), as well as the operational risk portion of the fourth quantitative impact survey (QIS-4). In this letter, the Financial Guardian Group would like to highlight issues raised in these reports that make clear that the pending proposal to impose a Pillar 1 regulatory capital charge for operational risk is for all practical purposes simply not possible. As the data make clear, the U.S. regulatory agencies face a stark choice: delay of the entire Basel II rules (with serious adverse competitiveness impact) or implementation of the rule on schedule with an operational risk requirement that will be based on untested, judgmental factors that undermines – not enhances – prudent operational risk capital and a meaningful economic capital charge. The best course, we continue to believe, is to implement as much of Basel II as possible as quickly as possible, covering operational risk under Pillar 2 unless or until the data and methodological problems highlighted in these surveys are resolved to widespread satisfaction.

As discussed below, both the QIS-4 and LDCE showed major variability among institution responses, with significant data gaps. These do not support any contention that large U.S. banks are ready for the advanced measurement approach (AMA), with the study itself arguing only that the data are getting better and "could potentially lead" to an improved understanding of operational risk. The FGG strongly supports this goal, and believes that efforts immediately to construct a regulatory capital charge in fact divert limited supervisory resources. This, in turn, exacerbates the perverse-incentive problem with an operational risk-based capital charge: Supervisors as well as banks are focusing on a highly-complex rule instead of urgently-needed qualitative operational risk mitigation.

QIS-4

Only fourteen of the twenty-four respondents to QIS-4 attempted to apply the AMA, with the remaining ten using the Basic Indicator Approach, a method that will not be allowed in the U.S.

Furthermore, no AMA approach employed by respondents has yet been validated by the regulators and the analysis showed substantial problems with its general application. The regulators note that, of the institutions attempting to employ the AMA:

- many were unable to apply all four elements;
- some only factored unexpected losses into their AMA capital calculations (The FGG has long advocated focusing the operational risk capital effort solely on unexpected loss);
- fewer than half used data derived from scenario analysis; and
- use of risk weightings varied widely.

Additionally, there was no empirical support for correlation and diversification assumptions used by any respondents, with all relying on undocumented "expert judgment." This, the study concludes, "could have significant impact on the risk exposure calculation," a key AMA component.

LDCE

Of the twenty-three reporting banks, only ten said that their data were complete, and those that did make this finding did so by self-assessment rather than regulatory validation. Further, regulators note that each bank judged its level of completeness using its own standards, which were likely to differ among each bank. Key conclusions and data here include:

- 96.3% of the roughly 1.5 million events represented only 21.8% of the losses and were primarily in the retail banking area;
- 1.5% of the events accounted for 74% of the losses;
- five of these individual events accounted for between 35% and 65% of the total operational loss, with a range given here to ensure reporting-institutions' confidentiality. These five incidents were heavily related to "client service problems," – that is, "failures of professional judgment," – and doubtless are the legal risk related to Enron, WorldCom, etc.; and
- four institutions accounted for 71% of the losses above $10,000, with those losses accounting for 67% of the total.

We note with particular interest the fact that loss frequencies remain relatively constant across the three LDCE exercises (2000, 2001 and 2004), but severities are dramatically different. For example, business disruption is cited in all three surveys, but severity spikes up in the 2001 survey – the 9/11 impact, of course. Similarly, "client services" are cited in all three surveys with relatively constant frequency, but severity goes way up in 2004 due to the cases noted above. From this, it is hard to see what these surveys show about catastrophic risk and how this could be incorporated into a meaningful capital charge.

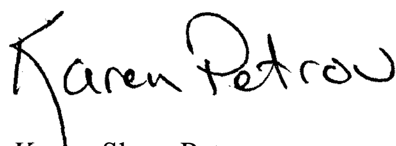
Additionally, respondents had difficulty mapping their own lines of business to the appropriate Basel categories, prompting regulators to create an "other" category, which accounted for 8% of reported loss frequency – but totaled 70.8% of loss severity. With regard to loss frequency in lines of business, retail banking suffered 61% of reported losses, mostly due to external fraud or execution, while the asset management and corporate finance lines of business suffered the fewest number of losses, at 2.4% and 0.3% respectively. However, while all banks reported data on retail business lines, less than half gave information on corporate finance. The frequency concentration in retail is of note because these losses – bounced checks, credit-card fraud, etc. – are typically priced into retail banking services,

as well as covered by reserves and future margin income, supporting the argument that capital should cover only unexpected loss.

As a new feature to this LDCE, regulators requested data on loss recovery, although they limited the time of recovery to one year. Data here showed that only 2.2% of big losses had insurance recovery, with recovery amounts varying significantly. As we have indicated previously on more than one occasion, recoveries from the carriers for large losses are usually not received until the matters in dispute are resolved entirely, which will usually take a number of years, depending on the amount that is being sought to be recovered. Of the reported recoveries, 20.8% were related to physical damage, with 72.7% of the loss amount successfully recovered. Again noting potential data problems, the regulators state that it is likely that banks may have failed to report insurance recoveries rather than having actually failed to recover operational losses. We strongly urge that this poor data not be used to substantiate assertions that there should be limits on recognizing insurance as an operational risk mitigation.

We would be pleased to discuss these views in further detail and provide additional information as may be of use.

Sincerely,



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