



EBA CP on Draft RTS on assessment methodologies for the Advanced Measurement Approaches for operational risk under Article 312 of CRR

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Mandate

- Article 312(4) mandates the EBA to develop technical standards to specify the following:
 - a) **The assessment methodology under which the competent authorities permit institutions to use Advanced Measurement Approaches;**
 - b) The conditions for assessing the materiality of extensions and changes to the Advanced Measurement Approaches;
 - c) The modalities of the notification required in paragraph 3 of Article 312 of the CRR.
- Points (b) and (c) of this Article have been included in the RTS on the 'Conditions for assessing the materiality of extensions and changes of internal approaches when calculating own funds requirements for credit and operational risk', adopted by the Commission on 12 March 2014.
- These draft RTS should therefore be read in conjunction with the RTS mandated under points b) and c).

Sources of the draft RTS on AMA



- The RTS on AMA are based on the Guidelines on the Advanced Approaches, issued by the CEBS/EBA in the past years and in particular on the:
 - *Guidelines on the implementation, validation and assessment of AMA and IRB approaches (GL-10 CEBS, issued on April 2006);*
 - *Compendium of Supplementary Guidelines on implementation issues of operational risk (GL-21 CEBS, issued on September 2009);*
 - *Guidelines on Operational Risk Mitigation Techniques (GL-25 CEBS, issued on December 2009)*

- The RTS on AMA also rely on documents on AMA issued by the BCBS (Insurance paper of Oct 2010, AMA Supervisory Guidelines of Jun 2011), Consortia standards, Supervisory experience gained in validation/review of AMA frameworks.

Objective of the draft RTS on AMA



- ❑ The evolutionary nature of the op risk discipline, the AMA in particular, naturally means a range of practice. Indeed, the Basel II Accord left a significant amount of flexibility to banks for the design of their AMA.
- ❑ However this flexibility has caused significant differences in the quality of the implemented AMA frameworks and has raised supervisory concerns regarding their effectiveness and consistency across banks and countries.
- ❑ These RTS represent a concrete answer to those concerns, as they aim to harmonize the standards across EU for critical components of an AMA.
- ❑ By doing so they should contribute to reduce the observed differences among the AMA and make their outcome more consistent with the banks op risk profiles and comparable each other.

Structure of the draft RTS

- I General provisions (including definitions)
- II Scope of operational risk and operational risk loss
- III Operational risk management
- IV Operational risk measurement
 - The four AMA elements
 - AMA modelling assumptions
 - Expected losses and dependence
 - Insurance and other risk transfer mechanisms
 - V Capital allocation
 - VI Parallel running
- V Data quality and IT infrastructure
- VI Use test
- VII Audit and internal validation

Article 6

Fraud events in the credit area → Question n.2

1. *Operational risk events occurring in a credit product or credit process, which are caused by ‘first party fraud’ or ‘third party fraud’ shall be classified as fraud events in the credit area. These events, and the related losses, **shall be included within the scope** of operational risk for the purpose of calculating the AMA regulatory capital.*
2. *The definition in paragraph 6(1) shall include the following events:*
 - (a) *lending decisions based on counterfeit documents or miss-stated financial statements, such as non-existence or over-estimation of collaterals and counterfeit salary confirmation;*
 - (b) *fraudulent use of credit funds;*
 - (c) *loan application fraud through phishing and using clients data;*
 - (d) *loan application by client using fictitious identity;*
 - (e) *fraudulent use of clients’ credit cards by third parties.*

Art. 6(4). For the purpose of this provision:

(1) **'first party fraud'** means a fraud that is committed by an individual or group of individuals on their own account with no intention of any repayment of the loss caused. A first party fraud generally occurs when the party misrepresents its financial abilities on the application forms and by using another person's identifying information. **Any fraud which is initiated at a later stage** of the lifecycle of a credit product, such as the misstatement of financial reports, even when it is used to prolong or to extend an existing credit product **does not fall** within this definition;

(2) **'third party fraud'** means a fraud that is committed by means of use of a person's identity, such as the use of false identification documents, without the knowledge of the person whose identity is used to commit the fraud. The fraudster can be an individual without a business relationship with the institution (external fraud) or an employee (internal fraud) and can involve existing client relationships (client is unaware) or new client relationships (real identity of client is unknown). If there is any active involvement of an existing client in the fraud, this is treated as first party fraud.

*Art 6(3). The competent authority shall verify that the institution adjusts the **data collection threshold** relating to the loss events described in Article 6(1) up to levels consistent with those adopted for the collection of the loss events pertinent to the other operational risk categories of the AMA framework.*

Article 8

Recorded loss amount of the operational risk items

The whole amount of the incurred loss or expenses shall be included in the scope of operational risk loss according to Article 7(1). This includes:

....

*(d) in case of fraud events in the credit area, **the total outstanding amount** at the time or after the discovery of the fraud (whole write-off amount, total credit loss) and any other related expenses, such as interest in arrears and legal fees.*

....

Article 7

Scope of operational risk loss

1. For the purpose of calculating the AMA regulatory capital, the scope of operational risk loss shall include the following items

(d) **pending losses** that are recognised to have a relevant impact. Pending losses shall be included **within a time period commensurate to the size and age of the pending item**. For this purpose, consideration shall be given to the recognition of pending losses actual amount in the loss database or pertinent scenario analysis;

(e) **uncollected revenues** related to contractual obligations with third parties, such as the decision to **compensate a client** following the operational risk event, rather than by a reimburse or direct payment, **through a revenue adjustment** waiving or reducing contractual fees for a specific future period of time;

Article 8

Recorded loss amount of the operational risk items

1. The whole amount of the incurred loss or expenses shall be included in the scope of operational risk loss according to Article 7(1). This includes:

*(c) in case of **tax payments** related to failures and/or inadequate processes, the expenses incurred as a result of the operational risk event, such as penalties, interest/late-payment charges, legal fees, **with the exclusion of the tax amount originally due;***

*3. In case of **timing losses**, the loss amount to be recorded comprises all the expenses incurred as a result of the operational risk event, including the correction of the financial statement, when it **involves the direct relation with third parties** (such as customers or authorities) or **employees** of the institution, and excluding the correction of the financial statement in all other cases.*

Article 11

Operational risk governance and management

1. *The competent authority shall evaluate the effectiveness of an institution's operational risk governance and management framework on the basis of their impact on **behaviour, engagement in operational risk management and culture**. The competent authority shall focus on:*

- (a) awareness of staff;*
- (b) operational risk culture;*
- (c) internal challenge process.*

2. *For purposes of Article 11(1), the competent authority shall verify that:*

*(f) an institution ensures that there is a regular evaluation of the effectiveness of the operational risk governance and risk management arrangements and **notifies the relevant competent authority of its findings**. Such evaluation and pertinent notification shall be carried out on **at least an annual basis**.*

Article 17

External loss data

*The competent authority shall verify that an institution that participates in consortia initiatives for the collection of operational risk events and losses **shall provide data of comparable quality, as to scope, integrity and comprehensiveness, to the internal data standards** set out in Article 16. Information obtained from consortia initiatives which have the abovementioned characteristics are an appropriate external data source for AMA capital calculation.*

Article 19

Business Environment and Internal Control Factors

*2. Given the subjective nature of BE&ICF adjustments, an institution shall have clear policy guidelines that **limit the magnitude of either positive or negative adjustments** as well as a policy to handle situations where the adjustments actually exceed these limits based on the current BE&ICFs.*

Building the calculation data set

5. *The competent authority shall verify that the choice of de minimis modeling threshold does not adversely impact the accuracy of the operational risk measures. In particular, the **use of de minimis modeling thresholds that are much higher than the data collection thresholds shall be limited** and, when established, properly justified by sensitivity analysis at various thresholds. **All operational losses above the set modelling threshold(s) shall be included in the calculation dataset** and used, whatever their amounts, for generating the AMA regulatory measures.*

8. *The competent authority shall verify that an institution ensures that **loss adjustments of single or linked events are not discarded** from the AMA calculation data set in the case that the reference date of these adjustments falls inside the observation period and the reference date of the initial (single or root) event falls outside such a period.*

9. *The competent authority shall verify that an institution shall be able to distinguish for each reference year included in the observation period the loss amounts pertinent to events discovered (accounted) in that year from the loss amounts pertinent to **adjustments or grouping of events discovered (accounted) in previous years.***

Article 23

Identification of the probability distributions

3. *The competent authority shall verify that an institution pays particular attention to the positive skewness and leptokurtosis of the data when selecting a **severity distribution**. When **the data are much dispersed in the tail**, empirical curves shall not be used to estimate the tail region. **Sub-exponential distributions** shall be used for this purpose unless there exist exceptional reasons to apply other functions, which shall be in any case properly addressed and fully justified to prevent undue reduction of the capital figures.*

....

7. *The competent authority shall verify that, when an institution adopts **robust estimators**, it can demonstrate that their use does not underestimate the risk in the tail.*

Article 25

Expected losses

2. *The competent authority shall verify that an institution's estimate of EL is consistent with the EL plus UL regulatory capital calculated using the operational risk measurement system. **The EL estimation process shall be done by operational risk category** and shall be consistent over time.*

Article 26

Dependence → Question n.5

3. *The competent authority shall verify that an institution carefully considers dependence between tail events. The dependence structure **shall not be based on Normal Gaussian or Normal-like distributions.***

Section IV - Insurance and other risk transfer mechanisms

The standards envisaged by the BCBS document 'Recognizing the risk-mitigating impact of insurance in operational risk modelling' (October 2010) are adopted.

Section VI – Parallel running

Article 34

General principles

2. In order to demonstrate the stability and robustness of the AMA output and to benchmark the AMA capital figure against the former approach, the competent authority in granting the permission to use the AMA shall request the institution to continue to parallel run for one year after the permission is granted.

Article 40

Supervisory assessment of IT infrastructure

3. *The competent authority shall verify that the **SDLC** for AMA purposes satisfies the best practice for software systems, which ensure sound and proper:*

- (a) project management, risk management, and governance;*
- (b) requirements engineering, quality assurance and test planning;*
- (c) systems modelling;*
- (d) systems development;*
- (e) quality assurance in all activities (including code reviews and if appropriate, code verification), and*
- (f) testing, which includes user acceptance.*

Article 1

Definition

*(25) ‘**System Development Life Cycle**’ means a process for planning, creating, testing, and deploying an IT infrastructure;*

Article 41 → Question n.6

Use test (not limited to regulatory purposes)

The competent authority shall verify that an institution ensures that the purpose and use of AMA are not limited to regulatory purposes, rather that:

.....

*(d) the operational risk measurement system is not only used for the calculation of the institution's regulatory own funds requirement in accordance with Articles 92(2)(e) and 312(2) of Regulation (EU) No 575/2013, but **also for the purposes of its internal capital adequacy assessment process** in accordance with Article 73 of Directive 2013/36/EU.*

Article 45

Audit and internal validation reviews

6. *The competent authority shall verify that the **audit and internal validation reviews** on the AMA framework are properly documented and their **output distributed to the appropriate recipients within the institutions**, such as the risk committees, operational risk management function, business line management and pertinent staff, if appropriate.*

7. *The competent authority shall verify that results of the **audit and internal validation reviews** including senior management's attestation are **summarized and reported at least annually** to the institutions management body, or a committee thereof, for approval. Attestation by senior management entails review and approval of the effectiveness of the institution's AMA framework on an annual basis.*



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