Memo to: European Banking Authority

From: Richard Apostolik
President & CEO

Date: August 18, 2014

Subject: Response to Consultation Paper on EBA Draft RTS and ITS on Benchmarking Portfolios

The Global Association of Risk Professionals is pleased to be given the opportunity to respond to the European Banking Authority's Consultation Paper on EBA Draft RTS and ITS on Benchmarking Portfolios (Consultation Paper). The foundation for our response is derived from over two years of analysis and detailed discussion among nineteen G-SIBs and internationally active banks[1] participating in GARP's benchmarking initiative (GBI).

GBI would like to compliment the EBA on its development of the Consultation Paper and for soliciting feedback. It is evident that the Paper's underlying analysis was through, thoughtful and objective. It affirmatively covers issues previously identified as being problematic in the development and analysis of hypothetical portfolio exercises (HPE). Further, the EBA appears to have taken into consideration informal feedback received from the industry as well as lessons learned from its studies to date. Consultations such as these, constructive debate and the increased communication being sought by the EBA and the industry will only result in a more positive experience for all concerned, a high level of confidence in future HPE studies, and greater understanding of the global risk-based capital regime.

GBI's Work to Date

GARP has been able to successfully pioneer GBI's concept due to the fact that it is totally independent and does not engage in any lobbying activities. GARP's core mission is education. Confidence in the results derived from studies and analysis conducted under the auspices of GBI can only be ensured if its sponsoring organization is independent and has no real or apparent conflict of interest in the outcomes. It also must be able to balance required industry expertise and leverage strong regulator relationships in a fashion that is non-biased and highly credible.

GBI's mission is to provide, in a non-partisan manner, an objective means to understand a bank's risk and capital measures, and to educate the markets about risk-related issues and approaches. To date, GBI's approach has included defining, calculating and distributing risk metrics based on pre-defined sets of underlying financial instruments (hypothetical portfolios) and convening senior risk executives and regulators to discuss operational issues associated with examinations of risk measure variability. GBI priorities include addressing and understanding the drivers of differences in bank risk and capital

[1] The following banks have been actively involved with and contributed to GARP's benchmarking initiative (GBI) over the last two plus years: Bank of America, Barclays, BNP Paribas, Citi, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, Intesa San Paolo, JPMorgan Chase, Morgan Stanley, Nomura International, Nordea, Royal Bank of Canada, Royal Bank of Scotland, Societe Generale, Westpac, National Australian Bank, Standard Chartered Bank.

assessments, and providing an objective platform to compare bank approaches to risk and capital measurement by portfolio type.

GBI has spent considerable time and effort analyzing and understanding the results, and issues, associated with the EBA's and Basel Committee's benchmarking efforts to date. This work has resulted in numerous conversations with global regulators addressing the various issues related to benchmarking based upon the use of hypothetical portfolios.

A primary result of GBI's efforts to date was the Bank of England/GARP HPE Operational Risk Workshop (Workshop) held on June 26 in London. The Workshop discussed and debated many of the issues that are asked to be addressed in the Consultation Paper. The Workshop also objectively and constructively suggested solutions to be considered by the banking and regulatory communities to help ensure that future HPE exercise results would be analyzed in a manner that considered the complexities and challenges faced by regulators and banks in developing and implementing these studies.

Recognizing that HPEs will remain a permanent part of the regulatory review and assessment landscape, GBI expects to continue with its work. The banks and their regulators are experiencing a learning curve around the development, implementation and analysis of HPE exercises. It is the expressed and sincere desire of GBI's bank participants that they and the regulatory community continue along a path of open and transparent cooperation as they work together to assess and address issues of systemic risk.

General Summary Points

- HPE objectives: the objective(s) of each HPE needs to be very clear and communicated to the banks with the exercise's portfolios/positions matched to the HPEs objective(s). Care should be taken to ensure that portfolio design suits the objectives of the HPE.

- Testing of market risk capital levels: to test the overall level of capital held by firms for market risk, the best choice is a diverse portfolio of linear/vanilla instruments with standard terms and conditions and liquid risk factors because this reflects the greatest potential for systemic exposure to material market risks and would encompass positions that are held by most globally interactive firms. (See question 5).

- Timing and quality assurance: in order to generate useful, robust and reliable results, data quality is of key importance. We recommend that the EBA ensures sufficient time is allowed for validation loops and provides comprehensive guidance through multiple channels. Recognizing the EBA is subject to certain mandated benchmarking development and timing constraints, consideration should be given to exploring ways for informal feedback to further ensure the exercises are conducted effectively and to reduce the risk of operational errors affecting the study's results. (See question 6.)

- Coordination of parallel exercises: given the many global regulatory initiatives requiring banks to respond to a variety of studies and exercises, and the limited supply of internal personnel resources able to timely perform the required work related to these studies and exercises, and to help guard against operational errors caused by these resource constraints, it is strongly recommended that the EBA engage with the Basel Committee for Banking Supervision (BCBS) and other global authorities to co-ordinate timing and content of HPE studies and other requirements. (See question 7.)

- Staged introduction: stable portfolio definitions are essential for the EBA to implement standardised reporting and to reduce the operational risks associated with changes. Given the complexities and challenges associated with defining portfolios in a standardized and unambiguous fashion, and the need for consultation between regulators and industry practitioners, described further herein, developing and implementing a basic set of portfolios and phasing-in additional portfolios over time allows learning to be taken into account. We support phasing-in over time (with reasonable lead times) rather than hoping to successfully define portfolios once and once only in the 2015 exercise. (See question 8).

- Position specifications: experience shows that the specification of positions and confirmation of terms and conditions is an exercise requiring a very practical approach. Electronic specification of positions through the use of an industry standard trade blotter is suggested. Further, the specification of portfolios (combinations of positions) needs to be very clear, flexible and subject to checks and input. (See questions 7 & 8).

Specific Responses to Consultation Paper

No.	Question	Response
1	**Do you consider the use of common benchmarks for credit and market portfolios necessary to ensure a common approach?**	The use of common benchmarks would be useful indicators of possible further inquiry if such benchmarks could be developed. However, the variables to be taken into consideration in their development are numerous and require a thorough analysis of such factors as company business models, modelling approaches and approvals, risk appetite assessments, materiality assessments relating to positions driving a bank's own fund requirements, concentration risks and other factors. *Moving toward a benchmark approach would require consultation between the regulators and the industry in their development, and ongoing maintenance.* Should benchmarks be developed, they should be considered as only "general guides to further inquiry" until such time as there is sufficient history to establish they can be used for more definite assessment purposes.
2	**Do you consider that the benchmarks outlined in the RTS are sufficiently proportionate and flexible? Do you have any alternative benchmark proposals? If yes, please provide details.**	The using of quartiles as an initial benchmark may be useful so long as there is recognition of their limitations (e.g., the size/materiality of the dispersion and clustering of results are not taken into account). Additional robust statistical measures such as mean absolute deviation from the median, and possibly others, should be considered as more experience is gained through the use of quartiles. Each addition of other factors should be slowly phased in and tested before being relied upon as an appropriate indicator of own fund sufficiency.

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3	**What limitations do you see in relation to the use of the proposed benchmarks, i.e., (i) first and the fourth quartiles; (ii) comparison between own funds under the internal models and the standardised approach; and (iii) comparison between estimates and outturns?**	The use of statistical metrics is only the first step in understanding variance. (See response to Question 1 above). This method does not separate variance due to operational errors from differences due to model differences among other things. Operational risk-driven errors should, as a priority, be reduced to an immaterial level before the variances can be measured and assessed with confidence.
4	**What in your view is the most appropriate benchmark and/or approach for the assessment of the level of potential underestimation of own funds requirements?**	Answering this question requires significant analysis and consultation. The answer will probably be the result of a combination of quantitative and qualitative analysis, to be assessed and analyzed over a period of time in order to ultimately reach an approach that is reliable for the purposes for which it was developed. A simple statistical approach may result in misleading conclusions without fully understanding all factors that would bear on the numbers.
5	**Which set of market risk portfolios do you consider more appropriate for the initial exercise conducted under Article 78?**	We support the use of GBI's benchmark portfolios for the purpose of testing comparability of RWA. A copy of the portfolios has been previously provided the EBA. As discussed at the BoE/GARP HPE workshop held on 26th June 2014 in London, portfolios need to suit the objectives of the HPE which could be: a) to test the overall level of capital held by firms for market risk b) to test the adequacy of the capital regime for instruments that could be difficult to model. For the first objective, a diverse portfolio of instruments having standard terms and conditions and liquid risk factors would be the best choice because such an HPE reflects the material drivers of RWA. As part of its benchmarking initiative, GBI developed such a set of hypothetical portfolios following a detailed review of the SIG hypothetical positions (which appear to be better suited to the second objective). The EBAs portfolios appear to have adopted some if not all of the principles developed and discussed in the GBI HPE Operational Risk Whitepaper made available at the BoE/GARP Workshop, a very welcomed development and we commend the EBA on its work in this regard. That being said, and assuming use of the SIG/EBA

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6		portfolios, they should be subjected to detailed consultation with representative industry practitioners to allow for discussion as to their applicability as they relate to the HPE's specifically defined objective(s), with the possibility of changes to more accurately measure the risk factors which are the subject of the HPE. It should be noted that with regard to the SIG portfolios that have previously been input into production or test environments, in whole or in part, have now been removed due to bank controls designed to mitigate the risk of rogue trading, and to ensure bank book and records are not affected by these hypothetical transactions. Re-booking these trades or any hypothetical portfolios is a major task that involves a number of specialized bank personnel and additional work related to ensure the bank's control environment appropriately accounts for the hypothetical trades. This relates to the importance of the use standardized terms and conditions, term sheets and other trade input requirements to reduce or eliminate the possibility of trade input operational errors that would affect the results of the study.
6	**As explained in the background section, do you consider the approach proposed by the EBA appropriate for future annual exercises?**	We suggest the approach incorporate the following "best practice" features: ▪ Allow sufficient time for multiple iterations during the validation stage. ▪ Perform a pilot with a limited number of firms. ▪ Effective communications of FAQs and other channels following the pilot and during validation stage are extremely important. As an example of how practice can be <u>ineffective</u>; during the April 2014 FRTB QIS, some firms received MV bounds after the first required business date. This did not allow enough time to re-book and re-run. Further, receiving MV bounds is not enough information to allow detection of operational errors, there needs to also be a discussion including risk sensitivities (the example of par instruments makes this clear but there is also the example of near-zero MV derivatives) and some type of pseudo-confirmation of the terms and conditions.
7	**Do you have any alternative proposals? If**	We support closer global coordination among and

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	yes, please provide details.	between regulators and among and between regulators and the banks on timing and content of HPE requirements and exercises. In order for results to be reliable and useful, submission of results should not take place until firms have come to a consensus on position specification, which should be driven through a more engaging validation process. A second phase to correcting this issue would be the development of term sheets for the positions, with a third phase including an electronic trade blotter for the input of trades. GBI reiterates its willingness to work with the EBA to develop term sheets for the portfolios adopted for HPE studies pursuant to this Consultation Paper and for future studies. The question on number of factors modelled for IRC (p13) should be clearer.
8	**Which of the two options for phasing-in do you consider preferable?**	Option 1 allows learning from the 2015 exercise to be incorporated into a larger set of portfolios for 2016. For this reason Option 1 is favoured over Option 2.
9	**Do you see any potential ambiguities in the credit risk portfolios defined in Annex I? Please identify the relevant portfolio providing details and any suggestions that would eliminate these ambiguities.**	GBI's work to date has been directed toward market risk portfolios. We are not prepared at this time to respond to specific questions relating to the credit risk portfolios identified.
10	**Do you have any suggestions for additional credit risk portfolios? Please provide details.**	See above answer.
11	**Do you see any potential ambiguities in the market risk portfolios defined in Annexes VII.a and VII.b? Please identify the relevant portfolio providing details and any suggestions that would eliminate these.**	Electronic specification of positions through the use of an industry standard trade blotter is recommended. Such a process would help eliminate position definition operational errors as it would avoid keying in data and capture terms and conditions in a standard format. We could not follow the definition of portfolios in terms of how to combine the various positions (section 3, Annex Vii.a). For example portfolio II is described as 1-50 instruments, 2-9 instruments and 3-1 instrument. We understood 1-50 instruments to mean long all

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		positions labelled as 1-50 in section 2. A spreadsheet list of which instruments to include in each sub-portfolio would be clearer as would including the possibilities of being long or short the position described in section 2 and in multiples of the quantity described. For example: Instruments 1. Long Eurostoxx 50 index OTC Future (1 point equals 10 € movement). Expiry - June 2014 2. Long OTC Future Banco Santander (1 contract = 100 shares). Expiry – June 2014 3. Long OTC Future Deutsche Bank (1 contract = 100 shares). Expiry – June 2014 4. Long OTC future, Banco Popular (1 contract = 100 shares). Expiry – 30 June 2014 5. Long OTC future, Commerzbank (1 contract = 100 shares). Expiry – 30 June 2014 6. Long OTC future, Caixa Bank (1 contract = 100 shares). Expiry – 30 June 2014 7. Long OTC call Option. Underlying Bayer, ATM (1 contract = 100 shares). Expiry – 31 July 2014 8. Long OTC call Option. Underlying Bayer, ATM (1 contract = 100 shares). Expiry – 31 December 2014 9. Long OTC Future OMX Copenhagen 20 CAP (1 point equals 100 DKK movement). Expiry – 30 June 2014 10. Long call Option. Underlying Carlsberg B A/S, ATM (1 contract = 100 shares). Expiry – 31 July 2014 Portfolios I Long 1-10. II Long 1-5 and short 6-10. III Long 1-3 and short 8-10. Ambiguities in the instrument definitions will only come to light when positions are booked and subject to a validation process. Has consideration been given to the relative size of risk from different asset classes and risk types in order to make the “overall” portfolio representative of systemic RWA?
12	**Do you have any suggestions for additional market risk portfolios? Please provide details.**	We support the use of GBI’s benchmark portfolios for the purpose of testing comparability of RWA. As noted above, a copy of the portfolios has been

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		provided to the EBA. Modifications can be made to the portfolios following consultation with the EBA should additional risk factors need to be included or if any ambiguities exist. The portfolios were developed with direct and detailed input from GBI's banks. If it is decided that the EBA or SIG portfolios are to be adopted, GBI's banks would be very open to consulting with the either the EBA and/or the SIG about the portfolios to be used, bringing to bear their expertise to further develop the portfolios to help ensure they fully measure the risk factors for which they were developed. The objective would be to ensure that test results are as actionable as possible versus questioning their reliability and/or accuracy. Further to the above, it has been found by GBI's banks that the development of a qualitative questionnaire to assist in the analysis of the results may add material understanding to the analysis. GBI has developed two separate questionnaires related to the work it has done in its HPE studies. The questionnaires help to eliminate misunderstandings relating to how banks may have used certain approaches and provides for a much richer and nuanced analysis than can be achieved through a pure quantitative assessment.
13	**Do you agree with the possibility of allowing firms to refrain from reporting portfolios if one of the conditions stated in Article 3 is met?**	Yes.
14	**Do you have any suggestion about additional exemptions from reporting? If yes, please provide details.**	No comments at this time.

We would like to again thank the EBA for this opportunity to provide input into this very important issue. Practitioners working in close consultation with the regulatory community will significantly mitigate concerns about data accuracy and completeness, particularly with a process such as HPEs where the practitioner and regulatory communities are still experiencing a material learning curve. GBI feels strongly that the global financial services industry and its regulators need to work together to address matters of systemic risk. The Consultation Paper is a very positive step forward in ensuring the accuracy, reliability and usability of HPE exercises.

Should you have any questions, please feel free to contact me.