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European Banking Authority
Uploaded via website

Date 10 September 2014
Reference BR2206

Subject: NVB reaction to EBA CP 2014/08 on assessment methodologies for AMA

Dear Sir, Madam,

On behalf of the Dutch Banking Association[1] (NVB) I would like to thank you for giving us the opportunity to react to Consultation Paper 2014/08 - Draft Regulatory Technical Standards on assessment methodologies for the Advanced Measurement Approaches for operational risk under Article 312 of Regulation (EU) No 575/2013.

Next to the answers to the specific questions, we would like to share a number of general remarks and concerns. These pertain to:

1. The Interaction between the proposals and The Standardised Approach
2. Distinction between first party fraud and third party fraud
3. Data filtering
4. Use of date of discovery or the date of accounting

Ad 1- Interaction between the proposals and The Standardised Approach
The proposals regarding Credit Risk losses (question 2) and dependence modelling (question 5) are also related to The Standardised Approach (TSA). As these two changes will increase the level of capital for AMA, this could create an inconsistency with the TSA capital levels. Are any alignment exercises being planned?

Ad 2 - Distinction between first party fraud and third party fraud
The consultation paper proposes a distinction between first party fraud and third party fraud, but excludes "*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*" from first party fraud. It is not clear how banks should separate that category out of the other first party fraud cases. This separation process is expected to be very complicated, increasing the requirements on data collection and making adjustments to models necessary. The costs associated with this exercise are expected to be significant. Also, it may be expected that there will be insufficient historical data available.

[1] The Dutch Banking Association (NVB) is the representative voice of the Dutch banking community with over 90 member firms, large and small, domestic and international, carrying out business in the Dutch market and overseas. The NVB strives towards a strong, healthy and internationally competitive banking industry in the Netherlands, whilst working towards wider single market aims in Europe.

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Ad 3 – Data filtering
Article 17 2 (page 38) states that: "*The competent authority shall verify that an institution shall have a data filtering process in place which involves the selection of relevant external data, based on specific established criteria and that it is necessary to ensure that the external data being used is relevant and consistent with the risk profile of the institution. To avoid bias in parameter estimates, the filtering process shall result in consistent selection of data regardless of its loss amount; furthermore, if an institution permits exceptions to this selection process, it shall have a policy providing criteria for exceptions and documentation supporting the rationale for any exceptions.*" This article is not completely clear. Does it mean that filtering on loss amounts is not permitted anymore, even when this is an exception for which the criteria and rationale are properly documented? In our view, this would create an undesirable situation. We propose deleting "*regardless of its loss amount*".

Ad 4 – Use of date of discovery or the date of accounting
Article 21 4. (page 41) states that: *"The competent authority shall verify that an institution uses the date of discovery or the date of accounting for building the calculation dataset. The competent authority shall verify that an institution uses a date no later than the date of accounting or reserve for including legal related losses or provisions into the calculation dataset."* We would like to note that the use of 'date of discovery' or 'date of accounting' is incorrect for estimating dependencies (correlation). The proposed dates do not express the simultaneous occurrence of actual events. Also, the use of these dates could cause unwanted variability in the AMA incident frequencies.

This concludes our general feedback to the consultation paper. In the annex, you will find our answers to the questions. Please feel free to contact me at your convenience in case you have any questions or remarks.

Kind regards,

Onno Steins
Senior Advisor Prudential Regulation

Annex – Answers to the questions

Q1: Are the provisions included in these draft RTS on the assessment methodologies for the Advanced Measurement Approaches for operational risk sufficiently clear? Are there aspects that need to be elaborated further?

A: In certain areas, clarifications would be welcome. For instance, the definitions in article 7 (2) (c) and (d) are not sufficiently clear and do not add sufficient value. Obtaining the internal costs would require a lot of fact finding, and assessing the opportunity costs is also not a walk in the park. If it is decided to keep these requirements, more detailed definitions would be required in order to ensure consistent applications across banks. Another example where clarification would be welcome regards "*shall satisfy*" (P24). It would be helpful if guidelines were published about the implementation of this concept. Next to this, it would be appreciated if EBA could provide more information about the organisation of supervision, as it is not clear if there are going to be changes in this area.

In other areas, descriptions and guidance are added to Regulation (EU) No 575/2013 and Directive 2013/36/EU without those elements being mentioned in the Regulation and the Directive. For instance in article 2 (2) "*information and communication technology risks*" are explicitly brought into the scope of Operational Risk. Also in (12), legal risk is further clarified and expanded. Additionally, the definition of risk appetite in (23) differs from the recent FSB guidance[2] and article 12 (3e) introduces a "*budget for the operational management risk function*". All these additions need to be consistent and they are not only relevant for AMA Banks.

Article 33 (1b) introduces "*inherent risk*" as part of capital allocation. Since inherent risk can not be exactly measured, comparison with the risk management system will always be qualitative. We therefore propose to delete "*potential internal differences in inherent risk and*". Also clarification is requested on what is meant by "*quality of operational risk management and internal control*". As these terms are currently defined, they will not allow for a consistent implementation across the EU. These issues should be addressed by using Business Environmental & Internal Control Factors (KRIs) in arriving at the AMA result.

Q2: Do you support the treatment under an AMA regulatory capital of fraud events in the credit area, as envisaged in Article 6? Do you support the phase-in approach for its implementation as set out in Article 48?

A: First and foremost, article 6 contradicts CCR Article 322-3(b), which states that: "*An institution shall record the operational risk losses that are related to credit risk and that the institution has historically included in the internal credit risk databases in the operational risk databases and shall identify them separately. <u>Such losses shall not be subject to the operational risk charge, provided that the institution is required to continue to treat them as credit risk for the purposes of calculating own funds requirements.</u>*"

The NVB understands and supports the managerial aspect of managing this risk within ORM. However, the data collection of operational risk events is difficult. From a prudential perspective, it would be preferable to use the existing credit models and procedures to calculate the capital for these ORM losses. The primary objective is for the modelled capital to be as accurate as possible. The results of such events could be calculated by using the credit risk model, and subsequently be allocated to operational risk.

[2] FSB Principles for an Effective Risk Appetite Framework, November 2013.

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Next to these points, the proposal requires a substantial change in the existing data collection and modelling processes, both for operational risk and credit risk. Also the consequences in terms of capital requirements are unknown, and the benefits are unclear. What is key is the way management acts upon all cases of fraud and that its sources are dealt with effectively. Against this backdrop, the NVB advises to maintain the treatment under the credit risk umbrella, by increasing the threshold.

Q3: Do you support the collection of 'opportunity costs / loss revenues' and internal costs at least for managerial purposes, as envisaged in Article 7(2)?

A: Yes, the NVB supports the collection of this data. However, it should be noted that some opportunity costs and lost revenues can be very hard if not impossible to quantify, as the data is hard to collect. For instance when a customer chooses to discontinue its business with the bank after an operational risk event. Staff will have to assess the amount of lost business and this will require training.

Q4: Do you support the items in the lists of operational risk events in Articles 4, 5 and 6, and the items in the list of operational risk loss in Article 7? Or should more items be included in any of these lists?

A: With regard to legal risk; the definition of events related to legal risk is broadened beyond the strict legal requirements by including breaches of "*internal rules*". This does not accurately reflect "legal" risk because internal rules can be stricter than the legal requirements. In addition, the article brings conduct risk into focus through "*ethical conduct*". This is not related to "*legal*" risk. With regard to paragraphs 4 & 5 the first lines should be extended to "*(…) from the scope of operational risks related to legal risk*", since some examples given are operational risks. The exclusion of events that are not to be labelled as legal risk should not be the focus of regulation. These could be better stated as guidance.

Article 7 (2): The items mentioned are indeed relevant for management purposes but the completeness of these items will be difficult to prove. Improving the accuracy of information will come at great costs, while the improvement of the capital calculation is expected to be low.

It should be noted that a breakdown of the legal costs, as required by article 7(b) (1) is not very practical. The current practice is that law firms bill banks based on hours worked, not split by specific cases. Consequently this practice will have to be revised, making the processes less efficient.

Q5. Do you support that the dependence structure between operational risk events cannot be based on Gaussian or Normal-like distributions, as envisaged in Article 26 (3)? If not, how could it be ensured that correlations and dependencies are well-captured?

A: The NVB does not support this change. In the consultation is stated that:
a) The use of a Gaussian or Normal-like copula generally does not appear well suited for operational risk.
b) The 2008-2009 crisis indeed made it clear that the use of Gaussian or Normal-like functions and copulas have significantly underestimated market risk and credit risk tail events.
c) As tail events are usually the main drivers of operational risk, which is perceived as a more 'fat-tail kind of risk', dependencies in operational risk and consequently the embedded correlation structures in copulas have to be treated in a more conservative way.

However, regarding these three points the following comments need to be made:

a) Research on the existence of tail correlation has shown that there is no real proof for the existence of tail correlation[3]. This is the case for research done by individual banks and by ORX, where ORX has a very large dataset at their disposal. Consequently, one cannot simply state that the Gaussian copula does not appear well suited. We kindly request the EBA to provide information that formed the basis for this statement.
b) It might be true that a Gaussian copula understated the market risk and credit risk tail events. However, the experience from these two areas cannot simply be extrapolated to operational risk. The nature and modelling of operational risk differs significantly from the other two risk types.
c) Tail events are the main drivers of operational risk. These tail events however, are generally isolated incidents, and not the sum of correlated incidents. It should also be noted that incidents that are caused by a common operational risk are required to be registered as one incident, as is stated in BCBS 196[4].

As per the above, correlation in general is coincidental for operational risk, as true causal correlations are ruled out by the above. Historical data shows that companies are hit by severe single events. There might be a few known cases, but most of the large hits are stand alone events. Next to this, the effect of tail correlation is only a single component of operational risk modelling. Correlation modelling cannot be viewed separate from, for instance, the modelling of the severity distributions. It is not clear why correlation is being isolated. In our view, the use of tail correlation in itself does not necessarily result in inappropriate capital levels. Similarly, the absence of tail correlation in a model does not automatically mean that such a model underestimates the amount of capital. The appropriateness of the capital results cannot be judged on a single model element. It depends on many combined model aspects.

Although it is not our desired outcome, it should be noted that a transition period will be required in the event that changes to the modelling treatment of correlations and dependencies are required. Such a transition period will have to include time to finalise all the significant change procedures.

Q6: Do you support the use of the operational risk measurement system not only for the calculation of the AMA regulatory capital but also for the purposes of internal capital adequacy assessment, as envisaged in Article (42) (d)?

A: Yes, we support this approach, as it enhances consistency.

[3] ORX Analytics, "Dependence and Correlation Analysis", July 30, 2012 (page 2): "We generally find little evidence that extreme losses in one unit of measure are much more likely to occur when extreme losses are observed in other units of measure".

[4] BCBS 196, article 141, page 30: losses caused by a common operational risk event, which may materialise over a period of time, are grouped together and entered into the model as a single loss.