Position Paper in response to EBA consultation on draft regulatory technical standards on assessment methodologies for the advanced measurement approaches for operational risk under Article 312 of Regulation (EU) No 575/2013

POSITION PAPER

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Foreword

ABI and DIPO welcome the opportunity to comment on the EBA Draft on Regulatory Technical Standards.

This Position Paper is based on comments received from our members.

We found the document in line with the AMA Models adopted by Italian banks and interesting for all banks as it sets the standards for sound operational risk management.

However, a few, yet important, general comments are made below. In addition there are also some specific comments related to single articles.

At the end of the document you will find the answers to questions 1-6.

General comments

1. The **phase-in of the provisions** introduced must be carefully evaluated and we ask that, in particular for those relevant listed in article 6, adequately extended.

2. It will be important to reflect on (i) how the measures introduced can be considered even by **non-AMA banks** on their way to advanced methods and (ii) how to ensure uniformity of detection in the case of consortia that are participated in not only by advanced banks.

3. We recognize the objective of the EBA to put some constraints in the framework of advanced methods but we reiterate here the absolute importance of **preserving a range of approaches** that go from the standard ones to those where the degrees of freedom left to individual banks are still relevant.

Specific comments

Scope of operational risk and operational risk loss

Article 1 and 5 – Model Risk

It seems necessary to specify that model risk is intended as the inability to realize professional obligations with specific clients and/or as non-observance of rules because of faults, errors, fraudulent behaviors in model risk construction. In our opinion **Model Risk should not be restricted to Market risk (see article 5) – it should be useful to refer to CAD 2013/36 EU *'model risk' means the potential loss that an institution may incur, as a consequence of decisions that could be principally based on the output of internal models, due to errors in the development, implementation or use of such models* - but should encompass for example models in the credit risk and wealth risk management fields**

In our view the generic phrase "*with the exclusion of other kinds of risk*" should be deleted from art. 1.2; it should refer to the definition of operational risk and then make it clear that it does not include strategic and reputational risk. Risk of non-compliance, e.g., should not leave the operational risk perimeter.

Article 2 - Legal Risk

Art 2 defines legal risk as " *the risk of being sued or being the subject of a claim or proceedings due to non-compliance with legal or statutory responsibilities and/or to inaccurately drafted contracts. It also includes the exposure to newly enacted laws as well as to changes in interpretations of existing laws*".

Therefore it seems that legal risk arises **not only in the presence of decisions by third parties** (e.g. litigation, resolution through decisions of the Institute of mediation/Ombudsman, penalties/fines issued by supervisory authorities, etc.) **but even in the presence of a simple complaint sent directly by a customers to the bank** and related to *"non-compliance with legal or statutory responsibilities and/or to inaccurately drafted contracts"*.
In art. 4.2 (a), on the other hand, events related to legal risk are restricted to *"events triggered by legal settlements - either judicial, or out of court, arbitration, claims negotiations - or from the voluntary decision of an institution to bear the loss so as to avoid an upcoming legal risk"*.

In our view the second perimeter is the right one: in operation risk management steps (LDC, scenarios, etc.) legal risk events are:

- those that involve a **third party's** judgment (and not as in article 2, simply "*being subject of a claim*") or
- those where the **intervention of a third party is highly plausible** ("*upcoming legal risk*").

This perimeter (that in our view should also become the one used for the treatment of Timing losses and for all the peculiar steps in legal risk mitigation techniques) allows a sound **differentiation between legal risk events and pure operational risk events** like all the "good-natured complaint resolutions" or all actions undertaken voluntarily by the bank after the detection of mistakes/malfunctions.

With respect to the sentence "*It also includes the exposure to newly enacted laws as well as to changes in interpretations of existing laws"* it must be recognized that there is a **huge difference in changes in interpretations *pro-futuro* of existing laws** (situation that is a challenge for a bank's compliance and operational risk management process but can be tackled) **compared to a strict retroactive application of a new interpretation of existing laws** whose effects (i.e. fees) can cover past decades (there would be no way to mitigate these effects).Therefore, we would make an explicit request for a specific indication that **retroactive laws are not included in the minimum capital requirement operational risk field.**

Article 2, 7 and 8- Timing Losses

The general definition of Timing Losses shown in **article 2 (27)** states that

"*timing losses means negative economic impacts booked in an accounting period due to operational risk events impacting the cash flows or financial statements of previous accounting periods. Timing impacts typically relate to the occurrence of operational risk events that result in the temporary distortion of an institution's financial accounts (such as revenue overstatement, accounting errors and mark-to-market errors)*".
In addition, in the EBA document it is specified that:

- article 7 - , "*timing losses that span more than one accounting year and give rise to legal risks*" should be included in the operational risk losses;
- article 8.3 - "*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*".

From reading the examples in the explanatory box of article 8, it seems that timing losses must be collected if the following elements occur simultaneously:

- presence of legal risk;
- losses involving more than one accounting period;
- involvement of third parties (customers, authorities, employees, providers).

We would like to see confirmation of the fact that, when all the above three criteria occur simultaneously, **both the (i) make-up payments and (ii) the penalties and interest are included in the loss amount.**

If this is the case, should the make-up payments for the **current year** be included in the amount of the loss? In the example of a dispute with an employee for mobbing which refers to the restitution of wages, it is not clear if the make-up payments for the current year should be considered as operational risk loss.

How can a "*relevant operational risk event*" be identified (art. 7.2)? Some objective criteria such as those applied at the DIPO consortia level would also be useful in order to achieve a level playing field situation.

Article 2 – Event type

Even if not directly linked to the consultation document we would like to ask if the impact on AMA and also non-AMA models, due to the changes in the **Event Type 5** definition introduced in CRR (art. 324 table 3), has been properly evaluated.

Both at the single bank and consortia level, this change could lead to huge problems given that in Event Type 5 all losses connected with the disruption of services caused by external events have been traditionally collected. In other words the ET interpretation has always been broader.

Article 2 – Recovery

It is not clear why recoveries are received only from third parties; an institution could recover its losses also in other ways.

Article 6 – Fraud events in the credit area

We propose the following definition of first party fraud in art. 6.4:
"'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 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;"

Article 16 - Date of accounting or reserve

We agree that the internal loss data base should at least consider the date of occurrence (when available), the date of the discovery and the date of accounting or reserve.

With respect to the date of accounting or reserve, we believe **consortia should not necessarily indicate a date of accounting or reserve that is not useful for modeling purposes** (as peculiar to the single bank accounting policies and not necessarily linked to the soundness of its internal control system) and that is definitely not useful in order to improve the event mitigation approaches/process.

Article 17 – External Data

We agree that consortia can achieve comparable quality, as regards scope, integrity and comprehensiveness, in the internal data standards set out in Article 16, because they are based on internal data. In addition, as for DIPO, they are checked by the custodian and cross-checked by members.

Article 25 - Expected losses

We would ask for “clear capital substitutes” to be defined more clearly (art 25.4).

4. “*..Because exceptional operational risk losses do not fall within EL, specific reserves for any such events that have already occurred shall not qualify as allowable EL offsets.”*

We believe that the above criteria need to be completed by giving a view on **what the regulators refer to as “*exceptional operational risk losses”.***

Should their identification be based on **body/tail** cut-off level of the single ORC or should it be based on **qualitative/quantitative ex-ante thresholds?**

Anyway it needs to be underlined that at the CFO level a **provision** might be made in line with potential disbursement (according to IAS, disbursement probability has to be greater or equal to 50%) **and at the same time the event will also have an impact on OR capital requirement** (tail event).

Article 25 – Write down detraction

With regard to art (7a) and art (8d), we would like to have confirmation that (see art. 25) write-downs can be detracted from regulatory capital

Data quality and IT infrastructure

Article 37 - Data quality and IT infrastructure

Article 37 (2) specifies that “*The competent authority shall verify that the quality of data used in the AMA is maintained over time and for this purpose that the building and maintenance procedures are regularly analyzed by the institution”*. When it comes to maintenance over time, what does this mean? Is it sound to keep in line only the data used for AMA analysis and to store all other data in order to ensure system good performance?

Answers to Q1 to Q6

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?

See our General Comments

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?

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)?

No because the research is too expensive

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?

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?

Yes we do

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)?

Yes we do