



BANKING STAKEHOLDER GROUP

CONSULTATION ON EBA/CP/2014/08
ON DRAFT REGULATORY TECHNICAL STANDARDS
ON ASSESSMENT METHODOLOGIES FOR THE ADVANCED
MEASUREMENT APPROACHES FOR OPERATIONAL RISK
UNDER ARTICLE 312 REGULATION (EU) NO 575/2013

General Comments and Specific Remarks

BY THE EBA BANKING STAKEHOLDER GROUP

London, 12th September, 2014

Foreword and General Comments

On 12 June 2013, the European Banking Authority published the consultation paper on “Draft Regulatory Technical Standards on assessment methodologies for the Advanced Measurement Approaches for operational risk under Article 312 Regulation (EU) No 575/2013”. The Banking Stakeholder Group (BSG) welcomes the opportunity to comment on the above mentioned consultation paper. This section sets out some general comments before addressing the respective articles in the Consultative Paper (“CP”) 2014/08.

We welcome the efforts of the European Banking Authority to combine the hitherto coexisting requirements for the structuring of an Advanced Measurement Approach for operational risk in a single document. Precisely at times of large numbers of new regulatory proposals, it is very helpful for the institutions concerned to be able to refer to an overview document.

At the same time, while the CP contains specifications, which in our opinion deviate from the rules currently applicable, it does not clarify how such new specifications will be phased in and applied in practice. In our opinion, it is important for the document to explain how the new standards will affect institutions having models in place, which have already been accepted by the supervisory authorities in the past. It should be clarified, e.g., that the new specifications will become binding only for models and databases that are validated after the RTS enters into force, and therefore will not require any adaptations to databases with retrospective effect.

In the remainder of this opinion, we provide our detailed remarks to several paragraphs in the Consultation Paper.

Detailed Remarks

Recital 14 – Internal Reporting

The regular internal reporting is not only to be addressed to the management body and senior management, but also to be made available on a timely basis to all staff involved in the operational risk process.

In our view, making individual reports available for loss recorders and assessors would entail disproportionately high costs. We consider that it would be sufficient for the staff responsible for operational risk management (division heads and board members) to be included in the reporting.

Article 1(2) Operational risk events related to model risk

The model risk cited in this Article is not subsequently limited or defined. Model risk is already included in the scope of operational risk via the event category “product error”. We ask for clarification that, as far as model risk is concerned, it

is not a matter of extending this (already existing) inclusion. Furthermore, this is overlapping – and to some extent partially in contradiction – with the proposition contained in EBA/CP/2014/14 on model risk.

Article 2(12) Operational risk events related to legal risk

We welcome the definition of legal risk. In our opinion, this definition includes the risk of being sued for breach of statutory regulations. Accordingly, the of taking proceedings oneself to enforce existing claims would not come under this definition of legal risk. We ask for a clarification confirming that this assessment is correct.

Article 4(2)(a) Operational risk events related to legal risk

The definition of the concept of legal risk as part of operational risk also includes the aspect of “voluntary decisions of an institution to bear the loss so as to avoid an upcoming legal risk”.

Insofar as this refers to costs arising from out-of-court settlements, we agree to the proposed inclusion in operational risk. On the other hand, “genuine” goodwill cases, in which the credit institution decides to assume costs without an underlying operational risk event (e.g. no misconduct on the part of the institution), should not be classified as an operational loss. We ask for a clarification on this aspect of the definition of the legal risk.

Article 5(3)(g) Operational risk events related to market risk

According to Article 5(3)(g), unauthorised market positions taken in excess of limits are to be considered as operational risk events. In our opinion, excess of limits should not be included *per se* as an operational risk event. Our interpretation of the requirements of the consultation paper is that, as in the past, excess of limits should first be considered in the context of the established escalation process. Only in cases where excess of limits generates a (net) loss should this have to be considered in the internal model. On top of that, our interpretation is that, as in the past, only intentional unauthorised excess of limits are concerned.

Article 6 Fraud events in the credit area

Cases of fraud events in the credit area, which are attributable to “first party fraud” or “third party fraud”, are to be recorded in the future as operational risk losses and underpinned by own funds.

To avoid double counting, institutions should be authorised to subtract such fraud events from credit risk. However, this would involve considerable implementation effort for the institutions themselves, the data consortia, and the companies drawing up the rating. Especially in cases where an institution does

not simultaneously apply the IRBA in the credit risk and the AMA in the operational risk, major challenges would arise in implementation. This would concern, for example, institutions that do not apply AMA, but rely for credit risk on the rating procedures provided by joint data consortia. The question arises as to how the current rating procedures could remain in existence if some banks had to consider losses from the credit risk while some others do not. We therefore ask for clarification as to whether in future there will be a distinction between institutions applying the combination of IRBA and AMA and institutions which combine IRBA with a standardised approach to operational risk. We therefore advocate allowing a flat-rate deduction in the credit risk in order at least to mitigate the effect of double counting on the capital requirement.

For those applying the combination of IRBA and AMA, we ask for a prompt update of the IRBA assessment criteria in order to preserve the intrinsic consistency of the CRD standards.

Furthermore, we consider it impossible in practice to document all fraud events from the current customary minimum level for operational risk loss. The current threshold values for recording operational risk losses in the credit risk are many times higher than the limit now proposed. We expressly call for a review of the minimum level from which fraud events in the credit area must be recorded and if possible for it to be raised so that at least the small-scale retail business would be exempted from loss recording. We therefore suggest introducing a threshold.

Furthermore, we consider that the implementation deadline stipulated in Article 47 is far too short. A two-year transitional period would be insufficient to appropriately meet the challenges of double counting. In addition, a change in definition would interrupt the data history. In order to ensure the reliability of the data, a corresponding data stock including consideration of the credit risk would have to be built up. In any case, this requires more time than the 2-year period envisaged. Taking into consideration the technical implementation work, an appropriate transitional period should be about 5 years.

Furthermore, we advocate for a preservation of comparability across institutions belonging to different jurisdictions. In addition to the complexity of implementation in Operational and Credit Risks IT systems, it would induce an uneven playing field if it were to be applicable only to EBA regulated perimeter without any convergence with BCBS standards.

Article 7(1&2) Scope of operational risk loss

According to Article 7(2), opportunity costs are to be included in the scope of operational risk management as a supplement to the items listed in paragraph 1 for the purpose of calculating own funds. Conversely, this means that the items listed in Article 7(1) do not include any opportunity costs. However, such costs are in fact included in point (d) in respect of pending losses and point (e) in

respect of lost revenues, on account of compensation. In our opinion, this constitutes a contradiction. Furthermore, we consider that there is no need to extend the database for calculating own funds on the basis of an AMA model to include opportunity costs. In both cases (points (d) and (e)) there is no charge to the P&L. Moreover, in the case of pending losses, this cannot arise by definition (see Article 2, point 20). Likewise, it is unclear what a pending loss with a relevant impact is.

The extension of the database to include opportunity costs removes the hitherto clear delimitation of the database for calculating own funds excluding losses with relevance to profit and loss. We therefore request the deletion of points (d) and (e) as components of the database for the calculation of own funds in Article 7(1).

Moreover, we want to point out the difficulties of performing a fair estimation of cost of repair or replacement (Article 7 (1, b2)) and internal costs as mentioned in Article 7 (2 d). Indeed, after a risk event, one may choose to enhance the former situation rather than just to restore it. It is then quite unclear to assess which part of the cost should be considered to be included in the OR database. When deciding to take all the components of the enhancement, it would unduly burden the entities promoting enhancement rather than pure restoration. Considering internal costs, a precise assessment of overtime is quite complex considering that, in most of the cases, internal staff first perform a trade off with their other tasks and postpone it in order to focus on risk event treatment. Therefore, the overtime cost is not a fair assessment of the cost of OR losses.

In addition to opportunity costs and internal costs such as overtime and bonuses, it will in future be mandatory to also include in the operational risk database any near-misses and operational risk gains at least for AMA management purposes.

The implementation of this requirement would pose a large number of challenges for the institutions. On the one hand, we point out that in contrast to genuine losses, near-misses leave no “traces” behind in accounts and therefore recording these operational risk events in full cannot be guaranteed. On the other hand, the question arises as to what incentives could be given to staff to ensure the fullest possible recording throughout the institution. For these reasons, we advocate focusing solely on material, significant events.

In addition, it is unclear how near-misses are to be assessed and entered in the AMA model. In our view, it would be logical to refer to the indirect operational risk expenditure, such as for example the additional internal expense via risk scenarios, and build up corresponding operational risk management on this subject. Furthermore, decentralised recording of near-misses on a voluntary basis, in conjunction with a corresponding staff incentive scheme, is conceivable.

Article 8(1)(d) Recorded loss amount of the operational risk items

In case of fraud events in the credit area, the outstanding amount of credit at the time of discovery of the fraud is to be recorded as operational risk loss.

We consider the amount of the loss to be recorded to be problematic. The outstanding amount of credit at the time of discovery of the fraud does not necessarily correspond to the amount of the write-off and hence the true loss incurred. Further repayments of principal and proceeds from realisation of collateral should be eligible as loss mitigation. In particular, the amount of the credit guarantees collected and the associated amount of the unsecured portion would in practice have played a key role in the decision to grant the credit in the first place. Accordingly, it should also be possible to take into consideration the eligible value of the collateral in the assessment of the operational risk. We suggest, instead of the present proposal, allowing assessment of the loss to be undertaken on the basis of the amount of the reserve.

Article 8(3) Timing losses

According to Article 8(3), in the case of timing losses, corrections of the financial statement are to be recorded as losses if third parties (e.g. customers) are involved.

We have no doubts as to the usefulness of recording such events against the background of appropriate operational risk management. However, the question arises with respect to the assessment of why in previous accounting periods excessive income received cannot be taken into account as loss mitigation. We advocate being authorised to take such income into consideration appropriately.

Article 11(2)(f) Operational risk governance and management

Banks are called upon to carry out a regular evaluation of the effectiveness of the operational risk governance and management.

It is not clear to us in what form such an evaluation should take place. The explanatory box provides examples of a possible target image. However, no examples or specifications on assessment of the effectiveness of the operational risk governance and management are provided. We should appreciate receiving further explanations on this subject.

A concrete definition of the concept of “operational risk governance” in Article 11(2)(f) would also be helpful.

Article 16(4) Internal loss data

In the past, it was deliberate policy not to transfer internal loss data on an individual basis to the accounting system. One of the justifications for this is that

for part of the data (e.g. in capital market business), individual transfer will not be possible on account of the portfolio perspective. Likewise, facts may be recorded in a chronological order for several reference dates, so in these cases there are several dates of entry. The added value of recording the date of entry is not obvious to us. No institution would record as an operational risk loss anything which is not recorded in the external accounting system. Recording the dates of entry would also represent a considerable additional effort for the institutions and we would ask for clarification that this requirement will not be applied retrospectively.

Article 17(2) External loss data

The consultation paper specifies that a data filtering process is to be established for external loss data.

We ask for an explanation of how the use of data filters is to be implemented in future. It would be helpful to know whether this filtering is absolutely essential or whether only the possibility of accepting filtered external loss data is to be taken into consideration. An extension of the verification obligations compared to present practice should be avoided. We ask for clarification what filtering process is envisaged by EBA.

Article 19(2) Business environment and internal control factors

According to Article 19(2), the impact of risk indicators is to be limited and processes introduced in the event of limits being exceeded.

The requirement appears to be comprehensible as long as a lump-sum add-on or deduction on the basis of the total VaR for operational risk is concerned. We are not sure whether this requirement is also applicable to cases where risk indicators are not used as a stand-alone methodology, but they impact directly on potential loss calculations of specific scenario analysis (e.g worst case scenario). A limitation of the business environment and internal control factors would in this case lead to a situation where the risk of specific scenarios is capped indiscriminately. We assume that this is not intended and ask for clarification.

Article 21(3) Building the calculation data set

In the event of a small data set, the possibility to improve the database by extending the observation period is to be welcomed in principle. We request clarification of how this observation period can be reduced again at a later point in time if the data set is sufficient even with a shorter observation period at that time.

Article 23(3) Identification of the probability distribution

The object of the estimate is to obtain the best possible adaption of data to distributions. The ex ante prioritisation of sub-exponential distributions above other functions does not seem appropriate in this connection. Moreover, the quality of a loss distribution selection process is already and efficiently covered by Article 23 (6) and 23 (8) (respective attention is to be paid to kurtosis-related parameters and prescription of goodness-of-fit tests).

We request deletion.

Article 24 (4) Determination of aggregated loss distributions and risks measures

The competent authority shall verify that the risk measures fulfil the monotonic principle of risk. An operational risk measure is not “exposure based” and, therefore, the monotonic principle is quite doubtful. The OR profile is indeed very dependent on the efficiency of the internal control set up. There is, for instance, no direct link between the total cost of risk and the total capital requirement. On the contrary, it clearly depends on the structure of cost of risk. Therefore, we ask for further explanation.

The competent authority shall verify that the institution applies appropriate techniques to determine the aggregated loss distributions. Therefore, they should verify that the institutions apply techniques to avoid capping the maximum single loss.

It would be advantageous if EBA could give a precise definition of the word “capping” in order to avoid confusions. It may be necessary, in some rare cases, and from a technical point of view, to truncate the loss distribution on the right (which is mathematically not the same as capping and hopefully not meant by the EBA to be “capping”) to ensure an acceptable robustness by performing sensitivity analysis, especially against very high losses. This may occur, when the data- and the accordingly fitted distribution – have far outliers (which is most of the time the case by adding huge losses in a sensitivity analysis) and a very high tail. When huge losses are included in the data, they can get overweight, compared to the rest of the data, because of a too short history. The best fitted distribution (not right-truncated) may then generate unrealistic losses with a too high probability/duration.

In fact, it should be permitted by EBA to right-truncate the loss distribution for robustness purpose, provided the truncated point can be economically validated. Such a method has the advantage of being easily understood by controllers and provides sufficient transparency.

Article 26(1) Dependence

We ask for an explanation of how the combination of empirical data analysis and expert judgment called for in this Article is expected to work. We ask in particular for criteria to be stipulated on the basis of which it can be ascertained from when and how results of the empirical analysis can be enriched by expert judgment. Especially in the case of a model approval, this gives rise to a reliable framework for action for institutions for the interaction of quantitative methods and expert judgment.

Article 26 (3) Dependence

The consultation paper proposes not to use the Gaussian or Normal-like copulas for operational risk modelling. This judgment seems to be too blunt since the dependence structure depends mainly on the way the operational risk categories are defined, and on the way data are grouped. It may occur that the data is grouped in a way that the fit of a t-copula provides a high degree of freedom, which indeed means that a Gaussian-copula can model the dependency well.

It should also be differentiated how the dependence structure is defined. There is a difference in results whether the copula-assumption is to be applied only to the frequency distribution or to the aggregated loss distribution which dependency is to be modelled.

Furthermore, we do not support too prescriptive restrictions/recommendations for modelling choices, given the fact that banks need to produce the evidence that our modelisation choices are duly justified (article 26 (5)). It is not obvious that one could apply lessons learned from credit and market risks directly to operational risk without any consideration of both the data (see article 23 (2.a) which emphasizes the absolute necessity to study the data before taking any modelling assumption for instance) and the modelling framework.

We request deletion.

Article 33 (b)

In case of an internationally active bank, we understand that the assessment of the “home” regulator (in charge of Pillar I) prevails over “host” regulator for the allocation processes.

Article 45(2)(b) Audit and internal validation reviews

The consultation paper provides for a review at least on an annual basis of the integrity of the operational risk policies, processes and procedures.

We understand the background to this requirement that amended loss data and model results are in need of regular review. As far as the audit activities of

Internal Audit are concerned, a risk-oriented procedure has proved successful. A review of the operational risk processes and procedures at least on an annual basis is not in conformity with this approach. Instead, the regular examination could be linked to the severity matrix of the model change policy. An annual review would then be necessary for material or significant model extensions and changes in the AMA. If on the other hand there are only insignificant or no changes to the AMA, it should be possible to forgo an annual review in favour of the risk-oriented procedure.

Submitted on behalf of the EBA Banking Stakeholder Group

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