

Response to:

European Banking Authority Consultation Paper

EBA/CP/2014/08

Draft Regulatory Technical Standards (RTS) on assessment methodologies for the Advanced Measurement Approaches for Operational Risk under Article 312 of Regulation (EU) No 575/2013

http://www.c-eps.org/web/guest/news-press/calendar?p_p_id=8&p_p_lifecycle=0&p_p_state=normal&p_p_mode=view&p_p_col_id=column-1&p_p_col_count=1&_struts_action=%2Fcalendar%2Fview_event&_redirect=http%3A%2F%2Fwww.c-eps.org%2Fweb%2Fguest%2Fnews-press%2Fcalendar%3Fp_p_id%3D8%26p_p_lifecycle%3D0%26p_p_state%3Dnormal%26p_p_mode%3Dview%26p_p_col_id%3Dcolumn-1%26p_p_col_count%3D1%26_8_tabs1%3Devents%26_8_eventTypes%3Dconsultation%252Cdiscussion&_8_eventId=724759

This paper was made available on June 30, 2014.

Comments are due by the close of business September 12, 2014. Comments are to be submitted electronically using the six questions posed by the EBA (see below).

EBA Qu 1: 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?

Please see below further elaborated through many comments.

EBA Qu 2: Do you support the treatment under 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?

This topic is upon the boundary between Credit and Operational Risk, in particular when calculating regulatory capital. The clarification provided by the EBA is welcomed. The concerns relate to practicalities. The change will have an impact upon regulatory capital calculations and the capital estimates generated as a result. This will have an impact upon the Credit Risk Management function. The Credit Risk Management function cannot be expected to make such significant changes if the changes are not actively supported by the Credit Risk regulators.

Primarily, the change in event categorisation must be supported by the Credit Risk Management function and their regulators. For Credit Risk Management the implications range from data collection to data history in risk analysis to the amount of capital required for Credit Risk. Several Hungarian banking groups as an ORX external data consortium members are encouraged by the knowledge that a Regulatory Technical Standard will soon be published for Credit Risk. Within this Credit Risk consultative paper it will be necessary to see text with the same implications and effects as Article 6. The Operational Risk Management functions cannot be expected to implement data collection related to the credit area without the active support of regulators specialising in the credit area.

Secondly, the data collection threshold for credit-related events will have a significant impact upon firms collecting the data. Being several Hungarian banks a member of ORX via its foreign owners ORX has a threshold of €500,000 for the investigation of Credit Risk losses that may have Operational Risk elements. However, an interpretation of Article 6 §3 is that if firms collect their Operational Risk Losses from a lower threshold, for example €10,000 or even lower, then this is the threshold at which they must also collect data about fraud in the credit area. While a firm may have 100s of defaults with write-offs of €500,000 the same firm may have 100,000s of defaults with write-offs of €10,000 or lower. This increased workload is then compounded by the time that it takes the firm to determine if a fraud has, or has not, been committed.

A potential approach is to extend the phase-in concept to thresholds as well as time. For example the initial data collection target could use a relatively high threshold, such as €500,000. After the firms have embedded systems and been collecting this data, as operational risk losses, for a period of time then a review could be undertaken to determine if there is sufficient value in reducing the data collection threshold.

Furthermore boundary events also influence the capital requirement calculation models. the *explanatory box* under *Article nr. 6 and §2* states that fraud events must take part in the AMA capital calculation model as these events can rather be considered as operational risk and not credit risk anymore. However we do not find any direct information on that once these fraud events are included in the *operational risk capital requirement* calculation, then they are allowed to be excluded from the **credit risk capital requirement** calculation.

EBA Qu 3: 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. These items seem to be illogical to be treated as a loss component and to be covered by capital requirement as these are items that cannot always be directly linked to the specified operational risk event.

While "*opportunity costs / lost revenues*" (Article 7 §2) may influence the economic value of the firm there are practical issues to consider. The practical issues include how to estimate these values with a degree of consistency across the businesses and event types and a degree of accuracy. Given that it is unlikely that this practical issue will be resolved in the very near future, it is proposed that "*opportunity costs / lost revenues*" should be deleted.

Theoretically "*internal costs such as overtime or bonuses*" contribute to the total impact of an operational risk event upon the firm. However, the general ledger is not set-up to provide this information on a regular basis. For functions closely linked to the control environment, for example compliance, or reconciliations, or payments, or the legal department, their total HR costs are known.

In exceptional circumstances, for example a particularly large remediation project, then the cost of allocated internal staff may be available, but may not separately show overtime or bonuses.

It is proposed that "*internal costs such as overtime or bonuses*" should be deleted.

EBA Qu 4: 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?

No comment

EBA Qu 5: 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?

No. This kind of connection focuses on the dependency of the tail events and would only be logical if banks would fit only such kind of distributions to their data that describes the normal losses well and not the low frequency-high severity losses. However at several banks the real practice is not like this. Several banks use different type of distributions to fit to 'normal', so high frequency-lower severity events and heavy tail distributions to fit 'large', so low frequency-high severity losses. Provided that the large losses are modelled and fitted

properly there is no sense to assume higher tail dependence between the modelled operational risk categories than it is in reality.

There are other two impractical features of the Archimedean copulae. According to our experiences the dependence structure of the modelled operational risk categories is not general, it is rather pairwise (i.e. an internal and external fraud has higher dependency than an internal fraud and a damage to physical assets), but Archimedean copulae cannot model heterogeneous pairwise dependence.

Finally, another impractical feature of the Archimedean copulae is its numerical instability at least in terms of the available fact operational loss databases in Hungary. We have conducted a study to demonstrate the stability of the parameters for Archimedean copulae and it resulted that at least 70-100 observations are needed between the pairwise dependency of the modelled operational risk categories to provide stable and efficient results for a copula dependency, but most banks do not have a database from so many observed years. In our same study performed on the external data consortium, so ORX data we have performed the same analysis and indeed it is the Gauss and normal-like T-copula that provided the best estimation for the dependence structure.

EBA Qu 6: 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)?

No comment

Article 1: Scope of Operational Risk	
§2	<i>“The competent authority shall verify that an institution has included legal risk, information and communication technology risks, as well as <u>model risk</u>, within the scope of operational risk with the exclusion of other kinds of risk.”</i>
Comment	<p>Model Risk is not defined in the document, but is referred to in several places. Art 5 §2c, Art 5 §3h & I, Art 5 §5a & b. A distinction is drawn between models that have been through an internal review process, use the correct inputs, but give a “strange” answer due to the assumptions embedded in the model being breached and those that have not been reviewed or implemented incorrectly or use the wrong inputs.</p> <p>Without a definition or description of model risk then it is possible for its scope to be extended in unexpected ways, for example to include budgeting.</p>
Suggestion	<p>A definition of model risk could be “the incorrect selection, and/or computer implementation of or data inputs for a model or its use for purposes outside those for which the model was approved. The approval of a model is an independent formalised procedure or business process.”</p> <p>Scope – pricing models used for official valuations (mark-to-model), risk models (VAR, IRB, AMA – how to determine the loss amount?), or any other models as well?</p>

Article 1: Scope of Operational Risk	
§2	<i>“The competent authority shall verify that an institution has included legal risk, information and communication technology risks, as well as model risk, within the scope of operational risk with the exclusion of other kinds of risk.”</i>
Comment	The scope appears to be missing issues related to people – including ethics and culture, organisation, and process failures.
Suggestion	The scope of operational risk is missing some important elements from the definition of operational risk, in particular processes, systems, people or external events.

Article 1: Scope of Operational Risk	
§2	<i>“The competent authority shall verify that an institution has included legal risk, information and communication technology risks, as well as model risk, within the scope of operational risk <u>with the exclusion of other kinds of risk.</u>”</i>
Comment	The statement on exclusions is confusing especially as these “other kinds of risk” are not described. If risks such as Business, Strategic and Reputational are to be excluded (as per the definition of operational risk) then it will be better to mention them explicitly.
Suggestion	The reference to “the exclusion of other kinds of risk” is adding uncertainty to the scope. It would be preferable for these other risks to be labelled, for example Business, Project, Strategic and Reputational Risks. The alternative is to delete “the exclusion of other kinds of risk”.

Article 2: Definitions	
§12	<i>“legal risk’ means 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. “</i>
Comment	<p>Depending upon the jurisdiction, firms can be sued for a wide variety of issues, for example the coffee is too hot. As a result the “risk of being sued” is too broad and impractical. If a firm is being sued then there is no risk or uncertainty.</p> <p>Effectively all Legal Events have an element of Legal Risk.</p>
Suggestion	Due to the influence of jurisdiction on the likelihood of being sued and the range of potential lawsuits it is recommended that this element of the definition is deleted. The definition would become <i>“Legal Risk means the risk of loss from non-compliance with legal or statutory responsibilities and/or inaccurately drafted contracts. It also includes the exposure to newly enacted laws as well as to changes in interpretations of existing laws.”</i>

Article 2: Definitions	
§20	<i>“pending losses’ means losses stemming from operational risk events, which are temporarily booked in transitory and/or suspense accounts and are not yet reflected in the P&L statement. The impact of some events, such as legal events, internal frauds, damage to physical assets, may be known and clearly identifiable before these events are recognized through the establishment of a reserve;”</i>
Comment	<p>The concern appears to relate to perceived or actual misuse of suspense accounts and pending losses in relation to operational risk losses. These items are probably pending losses while the more certainty is achieved over the loss estimate, for example is it €10 Million or €10,000.</p> <p>The finance / accounting / control function operates pending losses and suspense accounts within the formal accounting standards.</p> <p>For clarity the second portion of the definition should be deleted.</p>
Suggestion	The operation of pending losses and suspense accounts are governed by the accounting standards. It is recommended to clarify the definition be deleting the sentence <i>“the impact of some events, such as legal events, internal frauds, damage to physical assets, may be known and clearly identifiable before these events are recognized through the establishment of a reserve”</i>

Article 4: Operational Risk Events related to Legal Risk	
§2 b	<i>“The definition in paragraph 1 shall include the following events: events related to decisions made by an internal competent decision-maker but breaching legislative or regulatory rules, <u>internal rules</u> or <u>ethical conduct</u>. “</i>
Comment	The reference to “internal rules” appears to effectively extend the scope of legal risk. In addition, it is not clear if these “internal rules” are principles, policies, standards or procedures. “Ethical conduct” suffers from some of the same concerns as “internal rules”. Presumably if a firm is acting unethically then there will be issues around “legislative or regulatory rules”.
Suggestion	Uncertainty is created about the exact nature of the internal rules (whether principles, policies, standards or procedures) and about the scope of legal risk. For clarity it is proposed to delete some text so that the paragraph becomes <i>“events related to decisions made by an internal competent decision-maker but breaching legislative or regulatory rules”</i> .

Article 4: Operational Risk Events related to Legal Risk	
§3 b	<i>“As a specification of the paragraph 2, the following cases shall be included within the scope of application of paragraph 2, points (a) or (b):” “expenses stemming from legal disputes or from interpretations of legislative or regulatory rules <u>which prove to be against industry practice</u> “</i>
Comment	The reference to industry practice is confusing. A number of industry practices have been found to be against “legislative or regulatory rules”.
Suggestion	For clarity it is proposed to delete some text so that the paragraph becomes <i>“expenses stemming from legal disputes or from interpretations of legislative or regulatory rules”</i> . This will remove potential confusion about the status of industry practices, some of which have been found to be against “legislative or regulatory rules”.

Article 4: Operational Risk Events related to Legal Risk	
§4	<i>“Events due to decisions or radical changes in the business environment, lack of responsiveness to changes in the business environment or improper implementation of decisions which did not breach any legislative or regulatory rules, internal rules or ethical conduct shall not be ascribed to operational risk. “</i>
Comment	This paragraph should be amended to provide consistency with paragraph 2b.
Suggestion	For clarity it is proposed to delete some text and achieve consistency with the proposal for paragraph 2b. The paragraph becomes <i>“Events due to decisions or radical changes in the business environment, lack of responsiveness to changes in the business environment or improper implementation of decisions which did not breach any legislative or regulatory rules shall not be ascribed to operational risk.”</i>

Article 4: Operational Risk Events related to Legal Risk	
§5 a	<i>“As a specification of the paragraph 4, the following events, and the related losses, shall be excluded from the scope of operational risk:”</i> <i>“events incurred by an institution as a result of senior management’s decisions or business choices, which do not breach any legislative or regulatory rule, internal rules or ethical conduct, or which are not triggered by legal risk; “</i>
Comment	Examples could include various forms of business or strategic risk. Given the exclusions from the definitions it would be helpful if the same terminology could be used here.
Suggestion	From the perspective of consistency with the definition of operational risk, it would be useful to explicitly mention Strategic and Reputational Risks as being excluded.

Article 4: Operational Risk Events related to Legal Risk	
§5 d	<p><i>“As a specification of the paragraph 4, the following events, and the related losses, shall be excluded from the scope of operational risk:”</i></p> <p><i>“refunds to customers and goodwill payments due to business opportunities, where no breach of legal or regulatory rules or ethical conduct have occurred. This applies only where the clients/counterparts are entirely at fault and an institution has fulfilled its obligations, such as reminding the clients or counterparts of their obligations on a timely basis.”</i></p>
Comment	This relates to exclusions. The issue is complexity of the text. A much simpler text is suggested below.
Suggestion	<p>For purposes of clarity it is recommended that the same effect can be achieved with fewer words.</p> <p><i>“All payments to customers that are not compensation or restitution for operational risks events incurred by the firm.”</i></p>

Article 5: Operational Risk Events related to Market Risk	
Heading	<i>“Operational Risk Events related to Market Risk”</i>
Comment	<p>Reading through this article it appears that it has the wrong label. When thinking about Market Risk the connection is with VAR calculations. So perhaps the focus should be upon the trading & sales business line.</p> <p>However, most of the events described in §2 could also happen in Retail Banking or other banking and finance activities.</p> <p>A more appropriate heading might be “Operational Risk and Transactions”.</p>
Suggestion	<p>For clarity and consistency it is proposed to re-label this Article “Operational Risk and Transactions”. Transaction involving products that give rise to market risk are a sub-set. Other transactions that can suffer from these operational risk events include Retail and/or Commercial Banking.</p> <p>There will be implications for paragraphs within this section.</p>

Article 5: Operational Risk Events related to Market Risk	
§1	<i>“Operational risk events occurring in market-related activities shall be classified as boundary events between operational risk and market risk. These events, and the related losses, shall be included within the scope of operational risk for the purpose of calculating the AMA regulatory capital “</i>
Comment	This paragraph needs to be re-worded to focus upon operational risks associated with transactions, in general, as opposed to just market-related activities.
Suggestion	<p>For consistency with the proposed label, this text needs to be amended.</p> <p><i>Operational risk events arising from transactions shall be included within the scope of operational risk for the purpose of calculating the AMA regulatory capital. These transactions may take place in anywhere across the group, for example Trading & Sales or Retail banking business lines.</i></p>

Article 5: Operational Risk Events related to Market Risk	
§2 c	<i>“The definition in paragraph 5(1) shall include the following events: “events due to wrong selection and/or implementation of the <u>model</u>, made outside a defined business process/formalised procedure and without a formalized, conscious risk-taking process; and “</i>
Comment	The issue here is the scope of model. This is connected to “model risk” and its lack of definition in Article 2. (see above comments on Article 1)
Suggestion	<p>Models and model risk are included in the scope of operational risk. However, the lack of a definition of model or model risk in Article 2 creates uncertainty about the interpretation and practical scope of this paragraph.</p> <p>If model risk is defined then this paragraph may no longer be needed. A definition of model risk could be “the incorrect selection, and/or computer implementation of or data inputs for a model or its use for purposes outside those for which the model was approved. The approval of a model is an independent formalised procedure or business process.”</p>

Article 5: Operational Risk Events related to Market Risk	
§2 d	<i>“The definition in paragraph 5(1) shall include the following events: “events due to inadequate data quality and unavailability of IT environment “</i>
Comment	Paragraph 2 appears to be missing any reference to data entry errors. This may be implied by paragraph 2d, but it is not clear.
Suggestion	For clarity, it is proposed to add a reference to data entry errors to Article 5 paragraph 2d. <i>“events due to inadequate data quality, including data entry errors, and unavailability of IT environment.”</i>

Article 5: Operational Risk Events related to Market Risk	
§3 b	<p><i>“As a specification of the paragraph 5(2), the following cases shall be included within the scope of application of Article 5(2), points (a), (b), (c) or (d) respectively: “</i></p> <p><i>“errors in classification due to the software used by the front and middle office; “</i></p>
Comment	From an unscientific poll, it appears that errors in data entries account for as many if not more errors than software errors.
Suggestion	For clarity, it is proposed to add a reference to data entry errors to Article 5 paragraph 3b. <i>“errors in classification due to data entry errors and/or the software used by the front and middle office.”</i>

Article 5: Operational Risk Events related to Market Risk	
§3 f	<p><i>“As a specification of the paragraph 5(2), the following cases shall be included within the scope of application of Article 5(2), points (a), (b), (c) or (d) respectively: “</i></p> <p><i>“failures in properly executing a stop loss; “</i></p>
Comment	This can be amended to keep it in line with the broader scope of the Article..
Suggestion	For consistency, it is proposed to amend Article 5 paragraph 3f to <i>“failure in properly executing customer orders.”</i> This paragraph can then also apply to incorrect execution of a payment instruction through a retail bank or adhering to an asset management mandate.

Article 5: Operational Risk Events related to Market Risk	
§3 g	<p><i>“As a specification of the paragraph 5(2), the following cases shall be included within the scope of application of Article 5(2), points (a), (b), (c) or (d) respectively: “</i></p> <p><i>“unauthorised market positions taken in excess of limits; “</i></p>
Comment	Operational Risk losses can arise when unauthorised positions are taken; it is not limited to market positions. These positions could be in relation to purchasing, recruiting staff, on granting credit lines.
Suggestion	For clarity and consistency, it is proposed to amend Article 5 paragraph 3g to <i>“positions taken in excess of allocated limits, whether market, credit, liquidity or other risks.”</i>

Article 6: Fraud events in the Credit Area	
§2	<p><i>“The definition in paragraph 6(1) shall include the following events:</i></p> <p><i>(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;</i></p> <p><i>(b) fraudulent use of credit funds;</i></p> <p><i>(c) loan application fraud through phishing and using clients data;</i></p> <p><i>(d) loan application by client using fictitious identity;</i></p> <p><i>(e) fraudulent use of clients’ credit cards by third parties “</i></p>
Comment	<p>The impression given is that fraud is only committed at the beginning and not during the life of a transaction.</p> <p>Further on there is no implication on how to treat those events that are not to be considered as ‘classical’ ‘application’ fraud events but happen during the life of a transaction and result the same criminal case on behalf of the bank as an application fraud would do. The most important group of these events is when no fraud happens during the application but later there is a misuse of the collateral and the bank cannot apply its rights (for example lien) on the collateral.</p>
Suggestion	<p>For consistency and clarity, Article 6 §2 needs to be amended. The draft treatment is that only fraud committed at the beginning of a transaction is to be treated as operational risk or any kind of the examples mentioned above should be treated as operational risk. Else if fraudulent details are provided during the life of a credit transaction then the fraud is still to be allocated to Credit Risk. If this is what is intended then it would lead to an inconsistent capital treatment of fraud – sometimes OR and sometimes CR depending upon the timing of the fraud.</p>

Article 6: Fraud events in the Credit Area	
§3	<p><i>“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 “</i></p>

Article 6: Fraud events in the Credit Area	
Comment	<p>A firm may use a threshold of €5,000 to collect its internal operational risk data. The same firm may use a threshold of €10,000 for modelling a particular unit of measure – operational risk category. The EBA proposal is that this €10,000 should also be used to investigate credit losses to see if there is an element of fraud.</p> <p>The prior comment relates to the efforts required to collect the volume of data. There are additional resource implications, the specialists who conduct forensic analysis to determine if a fraud has or has not been perpetrated.</p>
Suggestion	<p>There are some practicalities that should be considered in relation to Article 6 §3. Presently the thresholds for collecting operational risk loss data relate to the business line and their operational risk appetite. Requiring the initial data collection of fraud in the credit risk space at the same threshold is expected to raise a significant implementation challenge.</p> <p>In addition to the system challenges there may also be the need to recruit additional staff to perform the forensic analysis in order to determine whether a fraud has been committed. It is proposed that for an initial phase a relative high threshold is used (for example €500,000) which can then be lowered overtime as the benefits are assessed.</p>

Article 6: Fraud events in the Credit Area	
§4 1	<p><i>“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 “</i></p>
Comment	<p>There seems to be some overlap with the description of “third party fraud”.</p>
Suggestion	<p>For clarity, it is proposed to make changes to Article 6 §4.1. This paragraph refers to “<i>using another person’s identifying information</i>”. This appears to be more closely aligned with Third Party Fraud. As a result it is proposed that “<i>and using another person’s identifying information</i>” should be deleted.</p>

Article 7: Scope of Operational Risk Loss	
§1 d	<p><i>“For the purpose of calculating the AMA regulatory capital, the scope of operational risk loss shall include the following items “</i></p> <p><i>“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 <u>actual</u> amount in the loss database <u>or pertinent scenario analysis</u>; “</i></p>
Comment	A few changes to the drafting could improve this requirement.
Suggestion	<p>For clarity, it is proposed to amend Article 7 §1 d. The main reason that firms use pending losses and suspense accounts is due to the fact that they do not know the actual amount of the loss. It is proposed to delete “actual” so that the phrase becomes “<i>recognition of the pending loss amount in the loss database</i>”. This will need to be included in the AMA calculations by date of occurrence as the loss estimate has not yet been recognised in the P&L.</p> <p>The inclusion of “pertinent scenario analysis” when used in a paragraph on pending losses is confusing and should also be deleted.</p>

Article 7: Scope of Operational Risk Loss	
§1 e	<p><i>“For the purpose of calculating the AMA regulatory capital, the scope of operational risk loss shall include the following items “</i></p> <p><i>“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; “</i></p>
Comment	Uncollected Revenues are difficult to collect. When combined with the loss data collection threshold proposed for Credit Risk and regulatory verification this looks like a difficult standard to meet.
Suggestion	It is recognised and appreciated that uncollected revenues are an economic loss to the firm. However, capturing these losses is difficult. One potential data source, the General Ledger, is used to tracking things that did happen rather than things that did not happen. At least a high threshold should be agreed, with home regulator, for capturing uncollected revenues to that the banks could be able to fulfil this task.

Article 7: Scope of Operational Risk Loss	
§1 f	<p><i>“For the purpose of calculating the AMA regulatory capital, the scope of operational risk loss shall include the following items “</i></p> <p><i>“timing losses that span more than one accounting year and give rise to legal risks.”</i></p> <p><i>“</i></p>
Comment	It is not clear why only timing losses that give rise to legal risk, including the risk of being sued, should be included.
Suggestion	<p>For clarity, it is not clear why only timing losses that give rise to legal risk should be included in capital calculations.</p> <p>An earlier proposal related to the definition of legal risk (Article 2 §12) and the removal of the “risk of being sued”. If the indirect reference to being sued was intended as a threshold then it can be used explicitly rather than referring to legal risk. The alternative is to agree a threshold, with the home regulator, for the inclusion of timing losses in the AMA calculations.</p>

Article 7: Scope of Operational Risk Loss	
§2	<p><i>An institution shall record and use, at least for AMA management purposes, the following additional items when they originate from a relevant operational risk event:</i></p> <p><i>(a) near-misses;</i></p> <p><i>(b) operational risk gains;</i></p> <p><i>(c) opportunity costs/lost revenues;</i></p> <p><i>(d) internal costs such as overtime or bonuses</i></p>
Comment	© ‘opportunity costs/lost revenues’ and (d) internal costs` items seem to be illogical to be treated as a loss component and to be covered by capital requirement as these are items that cannot always be directly linked to the specified operational risk event. a) near misses would rather be collected also above a certain threshold agreed with the home regulator that is higher than the usual threshold for the collection of direct operation losses.
Suggestion	To delete point (c) and (d) from the wording.

Article 7: Scope of Operational Risk Loss	
§2	<p><i>An institution shall record and use, at least for <u>AMA management</u> purposes, the following additional items when they originate from a relevant operational risk event:</i></p> <p><i>(a) near-misses;</i></p> <p><i>(b) operational risk gains;</i></p> <p><i>(c) opportunity costs/lost revenues;</i></p> <p><i>(d) internal costs such as overtime or bonuses</i></p>
Comment	It is not clear what is meant by AMA management.
Suggestion	<p>Uncertainty has been created in Article 7 §2 by the use of the term “<i>AMA management</i>”. Is this intended to be operational risk management or the team managing the AMA model?</p> <p>This data is perceived as being useful for operational risk management.</p>

Article 8: Recorded Loss of the Operational Risk items	
§1 a	<p><i>“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: “</i></p> <p><i><u>“all the expenses incurred as a result of the operational risk event, such as provisions, costs of settlement, amounts paid to make good the damage, penalties, interest in arrears and legal fees;”</u></i></p>
Comment	There is uncertainty as to whether the expenses are internal and external or just external. Article 7 §1b1 refers to external expenses and §1b2 cost of repair.
Suggestion	For clarity, a change should be made to Article 8 §1a, in particular inserting “external”. It is proposed that this paragraph should be: <i>all the <u>external</u> expenses incurred as a result of the operational risk event, such as provisions, costs of settlement, amounts paid to make good the damage, penalties, interest in arrears and legal fees;</i>

Article 8: Recorded Loss of the Operational Risk items	
§1 d	<p><i>“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: “</i></p> <p><i><u>“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”</u></i></p>
Comment	<p>There is uncertainty as the “<i>total outstanding amount</i>” is not the same as the “<i>whole write-off, total credit loss</i>”. For a fraudulent mortgage the “<i>total outstanding amount</i>” might be €1,000,000, but the “<i>write-off</i>” might only be \$200,000 due to the value of the collateral. Additionally if there is fraud, it will no longer be a “credit loss” but an “operational risk loss”.</p> <p>In several cases AMA banks in the Hungarian banking sector have experienced different approach that is not included here. In case of loans that are not yet written-off the home regulator required the actual amount of provision as a best estimator for the amount of loss for operational risk as well.</p>
Suggestion	For clarity, a change should be made to Article 8 §1d. The paragraph refers to “ <i>total outstanding amount</i> ” and “ <i>whole write-off</i> ”. These, figures may not be the same and could be very different. The uncertainty may be caused by the role of recoveries. For example, a fraudulent mortgage might have a “ <i>total outstanding amount</i> ” of €1,000,000, but the “ <i>write-off</i> ” might only be \$200,000 due to the value

	<p>of the collateral.</p> <p>Also, if there is fraud it will no longer be a credit loss, but an operational risk loss.</p>
<p>Article 8: Recorded Loss of the Operational Risk items</p>	
§2	<p><i>“In case of rapidly recovered loss events, an institution may consider that only the loss net of the rapid recovery constitutes the loss to be included into the scope of operational risk loss. When the whole loss is rapidly recovered, the event is considered to be a near miss according to Article 7(2)(a) of this Regulation. For purposes of this Article 8, ‘rapidly recovered loss events’ means operational risk events that lead to losses that are recovered within five working days “</i></p>
Comment	<p>It would be useful to have confirmation that rapid recoveries can be complete or partial.</p>
Suggestion	<p>For clarity, it is proposed to amend Article 8 §2 to confirm that partial recoveries are included. Many events with rapid recoveries may also have costs which cannot be recovered, for example interest arrears. The recognition of partial recoveries provides a more accurate picture of the risks involved. The paragraph could become: <i>In case of rapidly recovered loss events, an institution may consider that only the loss net of the rapid recovery (<u>partial or whole</u>) constitutes the loss to be included into the scope of operational risk loss. When the whole loss is rapidly recovered, the event is considered to be a near miss according to Article 7(2)(a) of this Regulation. For purposes of this Article 8, ‘rapidly recovered loss events (<u>partial or whole</u>)’ means operational risk events that lead to losses that are recovered within five working days</i></p>

<p>Article 8: Recorded Loss of the Operational Risk items</p>	
§3	<p><i>“In case of timing losses, the loss amount to be recorded comprises <u>all the expenses</u> 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. “</i></p>
Comment	<p>As in Article 8 §a it is not clear if this refers to internal and external or just external expenses.</p>
Suggestion	<p>For clarity, it is proposed to amend Article 8 §3 to refer to “external expenses”. The paragraph would then become <i>“In case of timing losses, the loss amount to be recorded comprises all the <u>external</u> 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</i></p>

	<i>financial statement in all other cases.</i>
Article 8: Recorded Loss of the Operational Risk items	
§3	<i>“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, <u>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.</u>”</i>
Comment	The paragraph comments on aspects of timing losses that could be confusing. It is proposed to delete this last portion of the paragraph..
Suggestion	For clarity, it is proposed to amend Article 8 §3 by shortening it. The paragraph would then become <i>“In case of timing losses, the loss amount to be recorded comprises all the external 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.</i>

Article 17: External Loss Data	
§1	<i>“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 “</i>
Comment	This relates to the submission of data by individual ORX Members. Effectively this requirement is that all Members deliver to ORX data as required by the EBA for AMA firms.
Suggestion	Article 17 §1 needs an urgent review. Firstly, with 65 Members ORX collects data from firms in a wide variety of locations. It is not obvious that the requirements documented in this draft directive will be mirrored by the home regulators in all of these jurisdictions. The ORX dataset is richer for this diversity of location. Additionally it enables comparison with our peers and competitors, not all of whom are based in the EU.

Article 17: External Loss Data	
§1	<i>“<u>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.</u> Information obtained from consortia initiatives which have the abovementioned characteristics are an appropriate external data source for AMA capital calculation “</i>
Comment	This relates to the submission of data by individual ORX Members. Effectively this requirement is that Members deliver to ORX data of comparable quality that Members collect and use. This raises questions about reporting reserves & provisions as well as insurance recoveries.
Suggestion	<p>Article 17 §1 needs an urgent review. Firstly, this requirement implies that all reserves & provisions that we use for internal risk management and measurement purposes must also be reported to ORX. It will be difficult to achieve comprehensive delivery of reserves & provisions without creating additional jeopardy.</p> <p>Secondly, it implies that we would also be required to report all of our insurance recoveries to ORX. This information is often subject to a confidentiality agreement with our insurers. As a consequence we would not be able to report it without creating a conflict around confidentiality.</p>

Article 17: External Loss Data	
§1	<i>“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. <u>Information obtained from consortia initiatives which have the abovementioned characteristics are an appropriate external data source for AMA capital calculation</u>”</i>
Comment	This relates to the data supplied by ORX to its Members. Article 16 includes references to data collection thresholds. ORX has over 65 Members and there is no guarantee that all Members use the same thresholds for data collection or AMA modelling.
Suggestion	Article 17 §1 needs an urgent review. The ORX database is expected to meet these requirements from the perspective of data fields. However, the issue is one of thresholds. With over 65 Members the ORX Members are of varying size. The loss data collection threshold for the Global Loss Database, which is most comprehensive, has been set at €20,000. A way that the ORX Global Los database could meet the threshold requirement would be to lower its loss data to the lowest amongst its Members. This would put a particular stain upon the larger firms.

Article 18: Scenario analysis	
§1	<i>“For AMA purposes, the use of scenario analysis is not restricted to evaluating exposures to high severity events. In certain approaches or cases, scenarios may be used to provide information on the institutions overall operational risk exposure”</i>
Comment	It is not clear what is meant by ‘AMA purposes’, because the Hungarian regulation requires only the high severity scenarios to be included in the AMA capital calculation model. Other high frequency-lower severity risks are covered by different data sources in the AMA model.
Suggestion	We suggest to definitely outline that only high severity scenarios are to be included in the AMA capital calculation model.

Article 21: Building the calculation data set	
§3	<i>“The competent authority shall verify that, for operational risk categories with low frequency of events, an observation period greater than five years is adopted in order to ensure sufficient data to generate reliable operational risk measures”</i>
Comment	The issue is that firms making the transition from TSA to AMA usually only have 3 years of data. So this paragraph creates a conflict. There is no cross reference to Articles 34 – 36 which discuss parallel running.
Suggestion	A clarification is required to Article 21 §3. This paragraph states that the minimum acceptable data history is five years. However, the target for firms entering the parallel run is to have three years of data. As a result, transitional arrangements are recommended. This might be achieved by a cross reference to a suitable paragraph in Articles 34-36.

Article 21: Building the calculation data set	
§5	<i>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. <u>All operational losses above the set modelling threshold(s)</u> shall be included in the calculation dataset and used, whatever their amounts, for generating the AMA regulatory measures.</i>
Comment	There appears to be a conflict between this paragraph and Article 21 §1, which implies that firms can construct a relevant internal loss data set for use in AMA calculations.
Suggestion	A clarification to Article 21 §5 is requested. There appears to be a conflict between the requirement in this paragraph to use all operational risk losses and Article 21 §1 which implies that firms can construct relevant internal loss data sets.

Article 21: Building the calculation data set	
§7	<i>The competent authority shall verify that losses caused by a common operational risk event or by multiple events linked to a “single root-event” are grouped and entered into the calculation dataset as a single loss. The competent authority shall verify that possible exceptions are documented and properly addressed to prevent undue reduction of the capital figures</i>
§10	<i>For purposes of this Article, ‘root event’ means the initial operational risk event from which related events have been generated and/or pertinent losses emerged</i>
Comment	Depending upon the practical interpretation of “root event”, this could amend the data collection and aggregation requirements. For example, if the “root event” refers to a process / control failure (because the firm has implicitly or explicitly decided to accept the risk) then the events would be aggregated / grouped overtime. It is not clear if the time period for grouping matches the annual accounting period or crosses accounting periods. The practicalities may be similar to finding a root cause.
Suggestion	A clarification to Articles 21 §7 & 10 is requested in relation to “single root event” and “root event”. Conceptually the idea is understood and appreciated, however the concern relates to the practicality and supporting a consistent approach.

Article 21: Building the calculation data set	
§8	<i>"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 "</i>
Comment	The interpretation of this paragraph is that firms will need to record the date at which the loss amount is changed. Presently many firms collect the data at which the loss first enters the P&L, the Date of Recognition. Going forward firms will have to record each date for which there is an impact upon the accounts. For some firms this will present system challenges.
Suggestion	A clarification to Article 21 §8 is requested. Does this require firms to record the date for each and every change to the loss amount when it enters the accounts?

Article 24: Determination of aggregated loss distributions and risk
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measures	
§4	<p>"The competent authority shall verify that an institution ensures that the risk measure generated by the operational risk measurement system: (i) fulfils the monotonic principle of risk, which can be seen in the generation of higher (lower) capital requirements when the underlying risk profile increases (decreases) and (ii) is realistic from a managerial and economical perspective. For this purpose, the competent authority shall verify that the institution applies appropriate techniques to avoid:</p> <p>(a) capping the maximum single loss; "</p>
Comment	<p>After fitting and mixing the partial distributions the next important step in many AMA models is the simulation to establish enough number of observations that count for a stable calculation of the capital requirement. It is not clear that '<i>capping the maximum single loss</i>' relates to:</p> <ul style="list-style-type: none"> • an upper threshold that we use throughout the simulation process • or it relates to any additional expert/managerial decision to limit the final capital requirement figure. <p>If it relates to the first one then we do not consider this requirement realistic as virtually there will be no theoretical maximum loss and banks will simulate capital requirements to cover the endless zone, while in practice there some cap for possible biggest losses (for example you cannot loose more than you have).</p>
Suggestion	To delete this point from the regulation.

Article 25: Expected Losses	
§3	<p>"The competent authority shall verify that an institution defines the EL by using statistics that are less influenced by extreme losses, such as median and trimmed mean, especially in the case of medium/heavy tailed data. The maximum offset for EL shall be bounded by the total EL and, in each operational risk category, by the pertinent EL calculated according to the institution's operational risk measurement system applied to that category."</p>
Comment	<p>There are three commonly used definitions of expected loss:</p> <ol style="list-style-type: none"> Statistical e.g. 50% confidence interval Accounting Losses that are expected <p>The expected loss figure derived from statistical distributions will vary with the type of distribution and the data used.</p> <p>The perception is that the accounting standards narrowly define</p>

	<p>expected loss, especially with regard to the creation of specific or general reserves.</p> <p>The other issue is to make clear what the following sentence means: <i>'institution defines the EL by using statistics that are less influenced by extreme losses'</i>. There is a connection of this requirement with the definition of the term 'expected loss'. Does this mean that there must be specific loss distributions that quantify the expected loss amount and contain no extreme losses? At several banks the practice is to define the expected value of the final, simulated distribution (whose 99,9 percentile serves as the VaR figure) that contains all losses from all kind of data sources.</p>
Suggestion	<p>A clarification is recommended to Article 25 due to the uncertainty around the meaning and intention of "Expected Loss". The terms expected loss is regularly applied to a point on a statistical distribution, in connection with accounting reserves and losses that are expected. Which of these interpretations is intended by the EBA? There should be consistency with the term expected loss as used with Credit and Market Risks.</p>

Article 25: Expected Losses	
§2	<p><i>"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 <u>operational risk category</u> and shall be consistent over time"</i></p> <p><i>("operational risk category" means the level (such as the institution's organizational unit, operational risk event type, business line) at which the institution's operational risk measurement system generates a separate distribution for estimating potential operational losses. An operational risk category is homogeneous when its data are of the same or similar nature under the operational risk profile, independent when no form of dependence or correlation is identifiable across it, stationary when the characteristics of the data does not change when shifted in time or space;")</i></p>
Comment	<p>Given that capital calculations are applied to the entire bank, it is not clear why expected losses should be assessed at the level of "operational risk category" / Unit of Measure instead of the total firm.</p>
Suggestion	<p>A clarification is requested to Article 25 §2. It is not clear why the expected loss (however defined) should be assessed at the level of the "operational risk category". The capital adequacy is assessed at the level of the total firm and it seems appropriate to determine the expected loss at the same organisational level.</p>
Article 25: Expected Losses	

§4	<i>The competent authority shall verify that allowable offsets for EL in each operational risk category are <u>clear capital substitutes or otherwise</u> available to cover EL with a high degree of certainty over a one year time horizon. Where the offset is something other than provisions, its availability shall be limited to those operations with highly predictable, reasonable stable, routine losses. 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.</i>
Comment	It is not clear what is intended or meant by “clear capital substitutes or otherwise”.
Suggestion	A clarification is requested for Article 24 §4 on “ <i>clear capital substitutes or otherwise</i> ”. Expected losses for Market Risk are taken through the daily mark-to-market or mark-to-model processes. Expected Losses for Credit Risk are taken via the creation of provisions or reserves and these are taken from the P&L. Does “ <i>clear capital substitutes or otherwise</i> ” refer to the P&L?

Article 25: Expected Losses	
§4	<i>The competent authority shall verify that allowable offsets for EL in each operational risk category are <u>clear capital substitutes or otherwise</u> available to cover EL with a high degree of certainty over a one year time horizon. Where the offset is something other than provisions, its availability shall be limited to those operations with highly predictable, reasonable stable, routine losses. Because <u>exceptional operational risk losses</u> do not fall within EL, specific reserves for any such events that have already occurred shall not qualify as allowable EL offsets.</i>
Comment	It is not clear what is intended or meant by “exceptional operational risk losses”. The importance of this phrase is linked to the interpretation of “Expected Loss”.
Suggestion	A clarification is requested in Article 24 §4 on “ <i>exceptional operational risk loss</i> ”. This is linked to what is meant by expected losses. It appears that the creation of general reserves may not be permitted under the current accounting standards, but may be allowed in the future with the adoption of IFRS 9 and its impairment framework for expected losses linked to cash shortfalls expected of the life of the asset with the probability over the next 12 months. As a result, reserves for expected losses from certain assets may be transferable to operational risk following the migration of fraud from Credit to Operational Risk.
Article 33: Allocation Mechanism	
§1 b	<i>“The competent authority shall verify that an institution’s capital</i>

	<p><i>allocation mechanism is consistent with the institution's risk profile and is on forms with the overall design of the operational risk measurement system For this purpose, the competent authority shall verify the following"</i></p> <p><i>"Capital allocation shall take into account potential internal differences in inherent risk and quality of operational risk management and internal control between the business lines/units to which capital is allocated"</i></p>
Comment	<p>It is not clear if the capital allocation refers to business lines within a legal entity and /or legal entities within a jurisdiction, and/or legal entities between jurisdictions. If it is legal entities between jurisdictions then it is assumed that the host state regulator will accept the allocation algorithm accepted by the home state regulator.</p>
Suggestion	<p>A clarification is requested for Article 33 §1b on the granularity of the capital allocation. For example, does the capital allocation refer to business lines within a legal entity, legal entities within a jurisdiction or legal entities between jurisdictions? It is not clear why the regulators would focus upon the allocation of capital to business lines within a legal entity. The business lines within a legal entity are unlikely to correspond to regulatory business lines.</p>

Article 33: Allocation Mechanism	
§1 b	<p><i>“The competent authority shall verify that an institution’s capital allocation mechanism is consistent with the institution’s risk profile and is on forms with the overall design of the operational risk measurement system For this purpose, the competent authority shall verify the following”</i></p> <p><i>“Capital allocation shall take into account potential internal differences in inherent risk and <u>quality of operational risk management and internal control</u> between the business lines/units to which capital is allocated”</i></p>
Comment	<p>The intention behind “<u>quality of operational risk management and internal control</u>” is not clear. If the capital allocation between business lines is a zero sum game, then some business lines will be allocated less than prescribed by an algorithm. Is it a reference to perceived shortcomings in the use of Business Environment & Internal Control Factors (KRIs) and their integration into the AMA model?</p>
Suggestion	<p>A clarification is requested for Article 33 §1b on the “<u>quality of operational risk management and internal control</u>”. These terms are not sufficiently well defined to enable consistent implementation across the EU. From a perspective, these issues should be addressed by the use of Business Environmental & Internal Control Factors (KRIs) in arriving at the AMA result.</p> <p>If the level of granularity, at which the allocation is to be applied, is legal entity then, due to the zero sum game on the amount of capital, the topic gets more complex and needs buy-in from regulators of individual legal entities.</p>