Risk Accounting Standards Board's response

to the Consultation Paper on

"Draft Regulatory Technical Standards on the components of the Business indicator under Article 314(6)(a) of the CRR and the elements to be excluded from the Business Indicator under Article 314(6)(b) of the CRR"

"Draft Implementing Technical Standards on the mapping of the Business Indicator components with corresponding supervisory reporting references under Article 314(7) of the CRR"

"Draft Regulatory Technical Standards on the adjustments to the Business Indicator under Article 315(3)(a), (b) and (c) of the CRR"

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Executive Summary

This document presents a detailed response to the consultation paper on the regulatory and implementing technical standards proposed under the CRR3 framework, particularly focusing on the amendments and implications for the Business Indicator (BI) related to operational risk. Our responses are grounded in the Risk Accounting methodology, which in our view provides a robust framework for integrating operational risk quantification into standard accounting practices. This approach is particularly suited to addressing the nuanced requirements of the new regulatory framework, enhancing both the precision and relevance of operational risk assessments.

Rationale for Using the Risk Accounting Method:

Risk Accounting was chosen as the basis for our responses due to its several key advantages:

1. Quantitative Precision: It allows for the detailed quantification of risk exposures, which is critical in accurately assessing and managing the operational risks associated with financial institutions' activities, especially those described in the BI components.
2. Regulatory Alignment: This method enhances compliance with regulatory mandates by providing a clear, transparent, and auditable framework for risk reporting and management, which aligns well with the expectations of the CRR3 amendments.
3. Adaptability and Relevance: Risk Accounting supports adaptable and dynamic risk management practices that can be tailored to specific institutional needs and changes in the regulatory landscape, ensuring that responses remain relevant over time.

The adoption of Risk Accounting principles in responding to this consultation paper ensures that our recommendations are not only theoretically sound but also practically viable and aligned with both current regulatory expectations and the operational realities of financial institutions. This approach provides a comprehensive framework that can significantly enhance the effectiveness of the CRR3 framework in managing and reporting operational risks, thereby supporting the overarching goal of financial stability and transparency in the European banking sector.

Question 1:

What are your views with regards to the proposal for the ILDC component?

The Interest, Leases, and Dividends Component (ILDC) is proposed to capture a comprehensive scope of financial activities that influence operational risk through interest, lease, and dividend transactions. Assessing this from a risk accounting perspective offers a quantitatively precise method to account for operational risks associated with these transactions.

The Risk Accounting Perspective:

Risk Accounting, as elaborated in Peter J. Hughes many published academic papers[1,2] and his recent book "Risk Accounting[3]," as well as in independent studies[4], provides a robust framework for integrating operational risk quantification into standard accounting practices. This method is particularly suitable for evaluating the ILDC due to its emphasis on transparency and the precise quantification of risk exposures.

Arguments Supporting Risk Accounting for ILDC:

1. Quantification of Risk Exposures: Risk Accounting focuses on assigning measurable risk units to different operational activities. For ILDC, this could help in accurately assessing the risk exposure from interest rate fluctuations, lease obligations, and dividend policies, which are often subject to significant operational risk factors.
2. Integration with Financial Reporting: Implementing risk accounting can seamlessly integrate with existing financial reporting frameworks, making it easier for institutions to report operational risks alongside financial data. This integration aligns with the need for transparency in reporting components like ILDC, which significantly impact financial statements due to their nature and size.
3. Enhanced Risk Sensitivity: The Risk Accounting method improves the sensitivity of accounting systems to potential losses from operational risk, which is critical for components like ILDC. This enhanced sensitivity aids in better preparation and mitigation strategies against operational disruptions or failures.
4. Alignment with Regulatory Requirements: Given the regulatory focus on accurate and comprehensive risk reporting, the detailed quantification provided by Risk Accounting ensures compliance with such mandates more effectively than traditional methods. This is particularly important for the ILDC, where regulatory scrutiny is high due to the direct financial implications.

The proposal for the ILDC component, when assessed through the lens of Risk Accounting, shows promising potential for enhancing the operational risk framework of financial institutions. This method not only supports regulatory compliance but also fosters a deeper understanding of the risk landscape associated with financial transactions like interest, leases, and dividends.

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[1] "A test of the feasibility of a common risk accounting metric for enterprise risks" (by Peter Hughes & Julian Williams - source link)

[2] "A test of the inherent predictiveness of the RU, a new metric to express all forms of operational risk in banks" (by Peter Hughes & Mahmoud Marzouk - download link)

[3] "Risk Accounting" by Peter J. Hughes (Amazon link)

[4] "Time for a paradigm change: Problems with the financial industry's approach to operational risk" (by Tom Butler & Robert Brooks download link)

Question 2:

What are your views with regards to the proposal for the Services component?

The Services Component (SC) proposal focuses on accounting for the operational risk related to services, which includes fee and commission income and expenses, among other operational incomes and expenses. It captures a wide range of operational activities that directly affect an institution's profit and loss statement.

The Risk Accounting Perspective:

From the perspective of Risk Accounting, which aims to provide a more granular and accurate assessment of risk within financial institutions, this proposal could significantly enhance the way operational risks are measured and reported.

Arguments Supporting Risk Accounting for SC:

1. Detailed Risk Measurement: Risk Accounting allows for the detailed measurement of risks associated with service-related activities. This includes the risks tied to fee generation and commission-based services, which can be volatile and risk-prone. The proposed SC would benefit from this as it involves various service-based transactions that can be precisely quantified using risk units.
2. Improved Risk Management: By applying Risk Accounting to the SC, financial institutions can better manage risks by identifying high-risk areas within their service offerings. This improved visibility can lead to more effective control measures and risk mitigation strategies, thus enhancing overall operational risk management.
3. Regulatory Compliance: The SC under Risk Accounting can help institutions meet stringent regulatory requirements that call for detailed and transparent risk reporting. The ability of Risk Accounting to integrate with existing financial systems and its focus on regulatory compliance makes it suitable for managing the SC's reporting needs.
4. Enhanced Decision-Making: With a clearer understanding of where and how risks arise from service-based activities, institutions can make more informed decisions about their service offerings. This strategic advantage is critical in today’s competitive financial environment where services can differentiate an institution but also expose it to potential risks.

Applying Risk Accounting to the proposed Services Component can provide significant benefits by enhancing risk visibility, improving risk management practices, and ensuring compliance with regulatory standards. This approach aligns with the needs of modern financial institutions that are increasingly focused on precision and detail in their operational risk frameworks.

Question 3:

What are your views with regards to the proposal for the financial component?

The Financial Component (FC) of the Business Indicator captures the gains and losses from financial transactions in both the trading and banking books, reflecting the operational risks associated with financial market activities. The proposal aims to fine-tune the inclusion of these items, considering both accounting standards and prudential regulatory requirements.

The Risk Accounting Perspective:

From the perspective of Risk Accounting, this component is critical as it deals directly with the financial outcomes of operational activities, which can be significantly volatile and risk laden. Risk Accounting offers a framework to more accurately reflect the financial impacts associated with operational risks in these areas.

Arguments Supporting Risk Accounting for FC:

1. Accurate Risk Quantification: Risk Accounting would enable institutions to assign specific risk weights to different types of financial transactions, reflecting their true risk profile. This could be particularly beneficial for the FC, as it involves complex and often high-risk financial activities that impact both the trading and banking books.
2. Alignment with Prudential Standards: The application of Risk Accounting aligns well with the need for a prudential approach as suggested in the FC proposal. By quantifying risks based on actual financial impacts and regulatory requirements, Risk Accounting can help ensure that the FC calculations reflect the true risk exposure of the institution.
3. Enhanced Transparency and Reporting: Risk Accounting promotes transparency and detailed reporting, which are critical for the FC. This component's focus on financial gains and losses requires a method that not only captures the immediate financial impacts but also the underlying operational risks that contribute to those outcomes.
4. Dynamic Risk Management: Implementing Risk Accounting allows for dynamic and responsive risk management practices. For the FC, where market conditions and financial regulations can change rapidly, having a flexible and responsive risk management framework is essential to maintain stability and compliance.

Incorporating Risk Accounting into the management of the Financial Component could significantly enhance the ability of financial institutions to manage and report on the operational risks associated with their financial transactions. This approach would provide a more robust, transparent, and compliant framework for capturing the true risk exposures in the trading and banking books.

Question 4:

What are your views with regards to the proposal for the specification of the items to be excluded from the BI?

The proposal for specifying the items to be excluded from the Business Indicator (BI) is designed to clarify and refine the operational risk calculations by removing certain elements that do not directly contribute to or reflect the institution's operational risk profile. This includes specific income and expenses from non-core activities like insurance distribution, which do not align with the main financial operations.

The Risk Accounting Perspective:

Risk Accounting's structured and detailed approach to risk measurement is particularly suited to determining which components should be excluded from the BI. This method ensures that only operational risks directly related to the institution's core financial activities are included, enhancing the accuracy of risk assessments.

Arguments Supporting Risk Accounting for BI Exclusions:

1. Precision in Risk Exclusion: Risk Accounting provides a methodological framework for precisely identifying and excluding items that do not contribute to operational risk. This precision supports the proposal's objective to refine the BI by ensuring that exclusions are clearly defined and justifiably omitted based on their lack of risk relevance.
2. Compliance and Consistency: By applying Risk Accounting principles, institutions can ensure that their BI calculations comply with regulatory standards while maintaining consistency across reporting periods. This is crucial for the proposed exclusions, which aim to standardize what is omitted from the BI calculations across the financial industry.
3. Enhanced Risk Management: With a clearer understanding of which items to exclude, institutions can better manage their remaining risk exposures. Risk Accounting helps in quantifying the impact of excluded items on the overall risk profile, ensuring that significant risks are not inadvertently omitted.
4. Strategic Decision Making: The clarity provided by Risk Accounting regarding risk exclusions can aid in strategic decision-making. Institutions can more effectively align their business strategies with their risk appetite and regulatory requirements, focusing on core activities that drive their risk profile.

The proposal for specifying items to be excluded from the BI, when considered through the lens of Risk Accounting, offers a robust framework for ensuring that BI calculations are both accurate and regulatory compliant. This approach not only enhances the precision of operational risk management but also supports strategic business decisions by clearly delineating non-risk-bearing activities. However, the danger in allowing exclusions is that over time they become set in stone and effectively fall outside the scope of active risk management and accounting. Risk management and accounting has to be a proactive and dynamic engagement that at all times remains skeptical about exclusion of ‘non-core’ activities. Too much of the recent experience of financial institutions failing demonstrates that this skepticism has not been the case in the past.

Question 5:

What are your views with regards to the proposed mapping of the BI items to the FINREP cells?

The proposal for mapping Business Indicator (BI) items to FINREP cells is aimed at enhancing the consistency and accuracy of reporting by ensuring that BI components align directly with the reporting cells used in financial reporting under the FINREP framework. This mapping facilitates transparent and standardized reporting across institutions, crucial for regulatory reviews and comparisons.

The Risk Accounting Perspective:

Risk Accounting's detailed approach to quantifying and classifying risk can significantly contribute to the effectiveness of this mapping. By ensuring that each BI item is precisely matched to the correct FINREP cell, Risk Accounting helps maintain the integrity and accuracy of the data reported, which is essential for effective operational risk management.

Arguments Supporting Risk Accounting for Mapping BI Items to FINREP Cells:

1. Enhanced Accuracy: Risk Accounting provides a framework for accurately capturing and reporting financial data associated with operational risks. This precision is crucial when mapping BI items to FINREP cells, ensuring that each item is accurately categorized and reported in line with its true financial and risk implications.

2. Regulatory Compliance: The precise mapping facilitated by Risk Accounting supports compliance with regulatory reporting requirements. By aligning BI items correctly with FINREP cells, institutions can ensure that their reports meet regulatory standards, reducing the risk of errors and the potential for regulatory penalties.

3. Improved Data Integrity: Risk Accounting emphasizes the integrity of financial data through its rigorous accounting and risk quantification methods. This integrity is critical when implementing the proposed mappings, as it ensures that the data reflects the real operational risk exposures of the institution.

4. Facilitation of Automated Processes: The clarity and precision provided by Risk Accounting in mapping BI items to FINREP cells can facilitate the automation of reporting processes. Accurate mappings reduce the need for manual adjustments and reclassifications, streamlining reporting procedures and reducing operational costs.

The proposal for mapping BI items to FINREP cells, when viewed through the Risk Accounting lens, provides a robust framework for ensuring that financial reports accurately and consistently reflect the operational risks faced by financial institutions. This approach not only aids in regulatory compliance but also enhances the overall reliability and efficiency of financial reporting.

However, for risk management and accounting of financial institutions to be effective, the taxonomy configured by FINREP cells needs to be critically evaluated on a regular basis to ensure it keeps up to date and fit for the purpose of ensuring it adapts and remains relevant to changing business models across the sector.

Question 6:

What are your views with regards to consider the financial statements used for the final valuation as the only reference for the acquisition of activities under the baseline approach (i.e., full historical data)?

The proposal to use financial statements employed for the final valuation as the sole reference for acquisitions under the baseline approach seeks to standardize the assessment of acquired activities by relying on a consistent and audited data source. This approach aims to simplify the integration of acquired entities into the acquiring institution's operational risk framework by providing a clear and definitive financial snapshot at the point of acquisition.

The Risk Accounting Perspective:

From the perspective of Risk Accounting, which emphasizes the precise measurement and management of risk in financial activities, this proposal offers several advantages. However, it also requires careful consideration to ensure that it accurately captures the operational risks inherent in the acquired activities. All business and financial institutions, in addition to the preparation and filing of annual statutory financial statements, rely equally importantly on more frequently produced management accounts as a source for strategic and operational decision making. The two – statutory and management statements – should always be capable of reconciliation, but there is a considerable time lag between the annual reporting cycle and management accounting review and decision making. For relevant stakeholders this can create a significant asymmetry of information between financial institution management and others.

Arguments Supporting Risk Accounting for Using Final Valuation Financial Statements:

1. Accuracy of Risk Valuation: Risk Accounting principles focus on the accurate valuation of risks associated with financial statements. Using the financial statements from the final valuation as the baseline ensures that the risk assessments are based on the most relevant and recent financial information, which reflects the valuation agreed upon by both parties at the time of acquisition.
2. Consistency and Comparability: Employing a uniform reference for all acquisitions standardizes the process, making it easier to compare and contrast different acquisitions. This consistency is crucial for institutions that engage in frequent mergers and acquisitions, as it simplifies the integration process and ensures that all entities are assessed on a similar basis.
3. Regulatory Compliance: Using audited financial statements that have been used for the final valuation helps ensure compliance with financial reporting and regulatory standards. This compliance is critical, as it provides assurances to regulators and stakeholders that the operational risk associated with the acquired activities has been properly assessed and reported.
4. Potential Limitations: While the use of final valuation financial statements provides a clear and consistent reference, it may also pose challenges. These statements may not always capture the full historical risk profile of the entity, particularly if significant changes or anomalies occurred prior to the acquisition. Thus, while useful, this approach should be supplemented by additional risk assessments to capture any outlier risks not reflected in the final valuation statements.

Considering financial statements used for the final valuation as the only reference for acquisitions under the baseline approach aligns well with Risk Accounting principles

by ensuring accuracy, consistency, and compliance in operational risk assessments. However, to fully capture the risk landscape of acquired activities, this approach should be integrated with broader risk assessment practices that consider additional historical data and potential anomalies in risk patterns.

Question 7:

What are your views with regards to the proposed three alternative calculation approaches instead of a unique alternative approach to be defined?

The proposal to implement three alternative calculation approaches rather than a single defined alternative aims to offer flexibility and adaptability in operational risk management, particularly in complex scenarios such as mergers and acquisitions. This approach allows institutions to select the method that best reflects their operational reality and risk profile, potentially leading to more accurate and representative risk assessments.

The Risk Accounting Perspective:

From a Risk Accounting standpoint, which seeks to provide precise and context-sensitive measurements of risk exposures, the availability of multiple alternative approaches can be seen as a strength. This flexibility ensures that institutions can tailor their risk assessment processes to suit specific circumstances, enhancing the accuracy and relevance of the risk measurements.

Arguments Supporting Multiple Alternative Calculation Approaches:

1. Flexibility in Application: Different acquisitions or mergers may present unique challenges and risk profiles. Having multiple calculation methods allows institutions to choose an approach that best matches the specific context of each transaction, rather than being constrained by a one-size-fits-all method.
2. Enhanced Accuracy and Relevance: By selecting the most appropriate calculation method for each situation, institutions can ensure that their operational risk assessments are more accurate and reflective of the actual risks. This is particularly important in acquisitions, where the financial and operational profiles of the entities involved can vary significantly.
3. Adaptability to Data Availability: The varying availability and reliability of historical financial data post-acquisition can affect the feasibility of certain calculation methods. Multiple approaches provide the necessary leeway to adapt to the available data, ensuring that risk assessments are still possible even when comprehensive historical data are lacking.
4. Regulatory Compliance: Offering multiple approaches can also help institutions meet diverse regulatory requirements across different jurisdictions, where the acceptance of specific risk calculation methodologies may vary. This adaptability helps ensure compliance while still providing institutions with the tools to manage their risks effectively.
5. Potential for Complexity and Inconsistency: While multiple approaches offer flexibility, they can also introduce complexity into the risk assessment process and lead to inconsistencies in how different transactions are assessed. Institutions need robust governance and clear guidelines to manage this complexity and ensure consistency in their risk management practices.

The proposal to implement three alternative calculation approaches provides valuable flexibility and adaptability, aligning well with the principles of Risk Accounting by allowing for more tailored and context-specific risk assessments.

However, it is crucial for institutions to manage the potential complexity carefully to avoid inconsistencies and ensure that the chosen approach genuinely reflects the risk profile of each transaction.

Question 8:

What are your views with regards to not providing any alternative method but adjustment to the effective perimeter of the disposal?

The proposal to focus solely on adjusting the effective perimeter of the disposal without providing alternative methods aims to streamline the process and ensure clarity in the adjustments following disposals. This approach seeks to simplify the operational risk assessment process by directly adjusting the business indicators to reflect the current, post-disposal structure of the institution.

The Risk Accounting Perspective:

From a Risk Accounting standpoint, which emphasizes precise and accountable risk measurements, adjusting the effective perimeter of the disposal can provide a clear and direct way to reflect changes in operational risk exposure. However, the absence of alternative methods could limit flexibility in addressing complex disposals where the direct adjustment may not fully capture the nuances of the risk changes.

Arguments Supporting Adjustment to the Effective Perimeter Only:

1. Simplicity and Clarity: Focusing on perimeter adjustments simplifies the operational risk management process by providing a straightforward method for recalculating risk exposure post-disposal. This can enhance transparency and reduce the potential for errors in risk assessment.
2. Direct Impact on Risk Profile: Adjusting the effective perimeter directly reflects changes in the institution's structure and operations, ensuring that the operational risk profile is immediately updated to mirror the current state of the institution. This direct reflection is crucial for maintaining accurate and up-to-date risk assessments.
3. Regulatory Compliance: This approach may align well with regulatory expectations for clear and verifiable changes in risk profiles following disposals. By directly adjusting the perimeter, institutions can provide a clear trail of how disposals have impacted their risk exposure, facilitating regulatory reviews and compliance checks.

Potential Limitations and Considerations:

1. Lack of Flexibility: Without alternative methods, institutions may find it challenging to accurately assess operational risks in scenarios where disposals involve complex financial structures or where indirect effects on risk are significant. In such cases, perimeter adjustments alone may not sufficiently capture the full spectrum of risk changes.
2. Risk of Oversimplification: Relying solely on perimeter adjustments might oversimplify the actual risk dynamics, especially in large or complex institutions where disposals can have cascading effects on various aspects of operations that are not directly linked to the disposed assets or operations.
3. Need for Supplementary Risk Assessments: To address potential gaps in risk coverage by perimeter adjustments alone, institutions might need to implement supplementary risk assessment processes. These could include qualitative assessments or scenario analyses to ensure all relevant risk factors are considered.

Adjusting the effective perimeter of disposals provides a clear and straightforward method for updating operational risk assessments in line with structural changes.

However, from a Risk Accounting perspective, it is also crucial to recognize the potential limitations of this approach in capturing complex risk dynamics. Institutions may need to consider supplementary methods or assessments to ensure a comprehensive understanding of their operational risk landscape post-disposal.

Such supplementary methods or assessments need to be strongly justified, principles based, and directly relevant to the specific business model of the financial institution putting them forward.

Question 9:

What are your views with regards to the inclusion of a threshold? Please explain and provide arguments for your answer, as well, if applicable, further evidence on situations where BI adjustments as set out under articles 1 and 2 would not be feasible or deemed excessively cumbersome and identify potential consequences on the dynamics of the European financial markets.

The proposal to include a threshold for Business Indicator (BI) adjustments aims to reduce administrative burdens by setting a minimum impact level below which adjustments are not required. This approach seeks to balance the need for accurate and timely updates to the BI with the operational reality of managing frequent minor adjustments, which can be resource-intensive and disruptive.

The Risk Accounting Perspective:

From the standpoint of Risk Accounting, which prioritizes precise and efficient risk measurements, incorporating a threshold can help focus resources on significant changes that materially affect the institution's risk profile, while avoiding the inefficiencies associated with minor adjustments.

Arguments Supporting the Inclusion of a Threshold:

1. Efficiency in Risk Management: Implementing a threshold can streamline risk management processes by focusing efforts on significant changes that have a material impact on the institution's operational risk profile. This efficiency can reduce operational costs and free up resources for other critical risk management activities.
2. Reduction of Administrative Burden: Minor BI adjustments can be administratively cumbersome and may not significantly alter the institution's risk exposure. A threshold minimizes the frequency of these adjustments, reducing the administrative load and potential for error in continuous recalculations.
3. Enhanced Focus on Material Risks: By setting a threshold, institutions can ensure that their risk management and reporting efforts are concentrated on changes that are substantial enough to warrant attention, thereby enhancing the overall quality of risk management.

Potential Limitations and Considerations:

1. Risk of Underestimating Cumulative Effects: A threshold might lead to under-reporting of cumulative small changes that, taken together, could have a significant impact on an institution's risk profile. It's essential to consider how these smaller adjustments might aggregate over time, potentially requiring a mechanism to monitor and evaluate their cumulative effect.
2. Balancing Precision and Practicality: While a threshold simplifies the BI adjustment process, there is a risk that it could also lead to less precise risk measurements. Institutions must carefully calibrate the threshold to ensure

it strikes an appropriate balance between practicality and the need for precise risk quantification.

3. Potential Market Consequences: If widely adopted, thresholds could influence the dynamics of the European financial markets by potentially delaying the recognition of risk exposures. This delay might affect market perceptions and the responsiveness of institutions to emerging risks, impacting market stability and investor confidence.

Evidence on Feasibility and Cumbersomeness:

In situations involving frequent, minor acquisitions or disposals, the administrative effort required for continual BI adjustments can be disproportionate to their impact on operational risk. For example, frequent small-scale mergers or divestitures in a rapidly consolidating sector might necessitate continual recalibrations of the BI, diverting resources from other critical risk management activities. The inclusion of a threshold would mitigate these issues by focusing adjustments only on transactions that meet a predefined impact criterion, thereby maintaining operational efficiency and reducing the likelihood of errors.

Including a threshold for BI adjustments represents a pragmatic approach to operational risk management, helping institutions balance the need for precise risk quantification with practical limitations on resources and administrative capacity. Careful consideration and calibration of the threshold are essential to ensure that it effectively supports risk management objectives without compromising the institution's responsiveness to significant risk changes.

Question 10:

What are your views with regards to the basis for the calculation of the threshold? Please explain and provide arguments for your answer.

Determining the basis for calculating the threshold in Business Indicator (BI) adjustments is critical to ensuring that the threshold serves its intended purpose effectively. The basis must be appropriately set to ensure that only significant changes that impact the institution's risk profile are considered, while minor fluctuations that do not materially affect risk are excluded.

The Risk Accounting Perspective:

From the perspective of Risk Accounting, which emphasizes accuracy and relevance in risk measurements, the basis for calculating the threshold should be carefully chosen to reflect the actual risk implications of changes in the BI. This involves considering the nature of the business, the typical magnitude of operational risk changes, and the potential impact on the institution's overall risk profile.

Arguments for a Carefully Considered Basis for the Threshold Calculation:

1. Alignment with Risk Profile: The threshold should be aligned with the institution's specific risk profile and the nature of its operations. For example, larger institutions or those engaged in higher-risk activities might require a lower threshold to capture relevant changes more sensitively, while smaller or less risk-exposed institutions could operate effectively with a higher threshold.
2. Proportionality to Financial Impact: The threshold could be based on a percentage of the institution's revenue, profit, or capital, ensuring that adjustments are made only when the BI changes are proportional to the financial scale of the institution. This method ensures that the threshold is dynamically adjusted to the size and financial performance of the institution, maintaining its relevance over time.

3. Frequency of Changes: Institutions with frequent large-scale transactions may benefit from a dynamic threshold that adapts to the typical frequency and size of these changes, preventing the system from becoming overloaded with adjustments while still capturing significant risk shifts.
4. Regulatory Standards and Comparability: The basis for the threshold calculation should also consider regulatory expectations and the need for comparability across institutions. This involves setting a basis that not only meets internal management needs but also aligns with industry standards and regulatory frameworks to ensure consistency and fairness in reporting and risk management practices.
5. Sensitivity Analysis: Implementing sensitivity analyses to test different bases for the threshold calculation can help identify the most effective method that balances responsiveness with practicality. This approach allows institutions to empirically determine which basis most accurately reflects changes in operational risk that are material to their specific circumstances.

Potential Limitations and Considerations:

- Over or Under Estimation: Incorrectly set thresholds, whether too high or too low, can lead to either over-reporting of insignificant risk changes or under-reporting of crucial risk adjustments. Calibration of the threshold must be precise to avoid these pitfalls.
- Complexity in Implementation: Establishing a dynamic or proportionally based threshold may add complexity to the risk management process, requiring sophisticated systems and processes to implement effectively.

The basis for calculating the threshold for BI adjustments should be thoughtfully determined to align with the institution's risk profile, regulatory requirements, and operational realities. A well-calibrated threshold can enhance the efficiency and effectiveness of risk management by focusing resources on significant risk changes and maintaining compliance and comparability across the industry.

Question 11:

What are your views with regards to the level you consider would be appropriate for the threshold? Please explain and provide arguments for your answer.

Determining an appropriate level for the threshold in Business Indicator (BI) adjustments involves balancing the need to capture significant operational risks while avoiding undue burden from minor adjustments. The threshold level should reflect both the quantitative and qualitative aspects of changes that are relevant to the institution's operational risk profile.

The Risk Accounting Perspective:

From a Risk Accounting standpoint, which seeks precise and meaningful quantification of risk, setting an appropriate threshold level is essential to ensure that risk measurements and subsequent adjustments are both practical and reflective of true risk exposure. This perspective encourages setting a threshold that reflects the real-world implications of risk changes on the institution's operations and financial health.

Arguments for Setting an Appropriate Threshold Level:

1. Proportionality to Risk Exposure: The threshold should be proportional to the institution’s overall risk exposure. This can be determined by assessing past operational loss data, the volatility of the institution’s operations, and the typical scale of external events that have historically impacted the

institution. A percentage of average annual losses from operational risk could serve as a practical basis.

2. Financial Significance: The threshold could be set as a percentage of the institution's revenue or capital base, ensuring that adjustments are made only when the changes are financially significant. This approach ties the threshold directly to the financial health and scale of the institution, ensuring that it remains relevant under varying economic conditions.
3. Regulatory and Industry Benchmarks: Aligning the threshold with regulatory expectations and industry benchmarks can provide a standard measure that ensures consistency and fairness in reporting and risk management across the sector. This could involve setting the threshold level at a point where it is in line with regulatory guidelines or common practices among peer institutions.
4. Operational Impact: Consideration of the operational impact of risk changes is crucial. The threshold should be set at a level where changes below this point do not significantly alter the institution’s operational risk profile or necessitate changes in risk management strategies. This ensures that resources are focused on managing changes that truly affect operational stability.
5. Sensitivity Testing: Conducting sensitivity testing to determine how different threshold levels affect the reporting and management of operational risks can help identify an optimal level. This empirical approach allows institutions to see the practical effects of different thresholds and adjust them based on real-world outcomes.

Potential Limitations and Considerations:

- Dynamic Adjustments: As the institution grows or its risk profile changes, the threshold level may need to be adjusted. Maintaining a static threshold could lead to inefficiencies or inaccuracies over time.
- Risk of Complacency: Setting the threshold too high might lead to complacency, where smaller yet cumulatively significant risks are overlooked. Conversely, too low a threshold could lead to excessive administrative burden without commensurate risk management benefits.

An appropriate level for the threshold in BI adjustments should effectively balance the need to capture significant risks with the practicality of managing those risks. It should be set based on a combination of financial significance, regulatory standards, and the specific risk characteristics of the institution. Regular reviews and adjustments based on sensitivity testing and changes in the institution's operational and financial landscape are advisable to ensure ongoing relevance and effectiveness.

Conclusion

In conclusion, this document presents a comprehensive response to the consultation paper on the proposed amendments under the CRR3 framework, leveraging the Risk Accounting methodology to address the multifaceted aspects of operational risk management. Through detailed analysis and grounded arguments, we have explored the implications of the proposed components and measures, offering insights that merge theoretical soundness with practical applicability. Our adoption of Risk Accounting not only underscores our commitment to precision and regulatory alignment but also enhances our capability to adapt to and effectively manage the dynamic risk landscape faced by financial institutions.

Our responses have been meticulously crafted to ensure they reflect a deep understanding of the regulatory objectives, coupled with a pragmatic approach to

operational risk management. By aligning our strategies with the Risk Accounting framework, we aim to foster a more robust financial environment that not only complies with emerging regulations but also champions transparency and stability in the European banking sector. This approach, characterized by its rigor and strategic foresight, is designed to equip institutions with the tools necessary to navigate the complexities of financial operations and risk management effectively, ensuring sustained compliance and operational excellence.

We are confident that our recommendations, based on the Risk Accounting principles, will contribute positively to the ongoing discussions, and will assist in shaping a regulatory environment that is both stringent and supportive of the industry's growth and stability. This document is a testament to our proactive engagement and readiness to implement and adapt to regulatory changes that aim to safeguard the interests of all stakeholders in the financial markets.