

22 December 2009

Feedback to the consultation on CEBS's Guidelines on Operational Risk Mitigation Techniques (CP 25)

1. On 15 April 2009, CEBS submitted for public consultation its Guidelines on Operational Risk Mitigation Techniques. The consultation period ended on 7 July 2009. Four responses were received¹.
2. In addition to soliciting written comments, CEBS provided an opportunity for the industry to provide further input at a public hearing with CEBS experts on operational risk on 9 July 2009.
3. This paper presents a summary of the key points arising from the consultation and the changes made to address them.
4. The low participation and the relatively small number of comments probably resulted from the current situation in the financial markets and from the low number of products currently available in the field of Other Risk Transfer Mechanisms (ORTM).
5. Respondents also provided suggestions for further regulations and guidelines especially in the field of haircuts and the use of insurance for operational risk management purposes.
6. The Guidelines have been revised on the basis of the comments received and the inputs from the public hearing. The final guidelines have adopted some of the suggestions put forward for the topics under consultation. The most significant amendment concerns the use of all the information sources available to the institution (including internal data, external data and scenario estimates) to map insurance contracts to operational risk losses and to capture coverage mismatches of medium to large losses (due for instance to high deductibles and limits or to the exhaustion of policy limits).

¹ The public responses to CP25 are published on the CEBS public website under: <http://www.c-ebs.org/getdoc/8e04306e-e228-43dc-b17b-abd639f90c32/Responses-to-CP25.aspx>

7. A few suggestions have not been addressed because they are outside the scope of the consultation document. For example some respondents asked for additional clarifications of the recognition of insurance under Pillar II. As CEBS has not so far issued guidelines on these topics, the relevant authorities have to decide based on the national implementation of the EU Capital Requirement Directive (CRD) what is and what is not acceptable under Pillar II. Some other comments were aimed to changes to the CRD instead of amending the proposed guidelines and therefore have not been taken into account. However, those questions may be covered in future work by the CEBS.
8. In the Annex a feedback table is provided which gives a detailed description of the comments received and CEBS's responses to them.

Feedback table on CP25: analysis of the public responses and suggested amendments

CP25	Summary of comments received	CEBS's response	Amendments to the proposals set out in CP25
Guidelines on Operational Risk Mitigation Techniques			
Level of Application: AMA institutions			
Section 1. Introduction			
Paragraph 1	Respondents encouraged supervisors to incentivise banks using the standardised approaches to purchase insurance as this is a fruitful risk management tool.	<p>The CRD stipulates that AMA banks may benefit from the use of insurance through capital alleviation, while capital alleviation under the BIA or TSA regime is not possible, given the current rules of the CRD.</p> <p>For AMA institutions, the use of insurance management as a key "use test" principle has already been introduced in Par. 11, 3rd bullet point of the "Guidelines on the use test for AMA institutions", included into the Compendium (GL21; see also</p>	No change

		Par. 26 of the feedback document).	
Paragraphs 5 and 7	Respondents expressed some concerns that the Guidelines will not improve the conditions for the development of ORTM.	The Guidelines provided on ORTM contribute to ensuring convergence of supervisory practices in this area and provide a framework which is consistent with the one for insurance products. They add to the legal security needed to develop ORTM for the purposes of risk management and capital alleviation within the AMA.	Paragraph 5 and 7 amended to reflect the purpose of the Guidelines
Paragraph 7	Respondents expected that the dialogue on ORTM with the industry will be continued and that some insurance specific aspects to be applied to these products (e.g. haircuts, eligibility of providers and the 20% limit) will be discussed anew.	As mentioned in par. 7, CEBS will continue the dialogue with the industry on this matter. This includes supplementing and reviewing the guidelines when more experience and knowledge of those instruments has been gained within the industry and regulatory community. Regarding the 20% limit, the recent changes to the CRD have confirmed the CEBS's views. Up to now, the 20% limitation for AMA capital alleviation does not seem to restrict the use of risk mitigation techniques at all.	No change
Paragraph 14	Respondents supported that the mapping of insurance contracts needs to be sufficient granular but stated that the insurance impact should particularly be recognised within high severity scenarios, which could have a high impact on the AMA capital. Therefore the event-type mapping should follow the possible	Internal loss data collection contains information about losses and recoveries. As long as the internal data is relevant as required by Annex X, Part 3, No.	Paragraph 14 amended

	events and recognise scenario analysis instead of focussing on past payouts.	15 and No. 18 of the CRD they often provide the basis for the capital calculation including the calculation of the capital alleviation stemming from the use of insurance within the loss distribution approach. However, depending on the AMA model and the contribution of loss data and scenario analysis on the capital calculated, institutions should also assess the impact of insurance within scenario analysis and recognise this in the capital calculation.	
Paragraph 15	Respondents were worried that paragraph 15 takes a more restrictive approach to the use of captives and affiliates than intended by the Directive.	The CRD requires in Annex X, Part 3 No 27 (e) that “the insurance is provided by a third party entity. In the case of insurance through captives and affiliates, the exposure has to be laid off to an independent third party entity, for example through reinsurance, that meets the eligibility criteria.” The CEBS Guidelines do not intend to restrict this requirement, but aim to clarify how supervisors will assess if there is an effective transfer of risks outside the group.	No change
Paragraph 19	Respondents asked for the reasoning for the haircuts depending on the maturity of products.	The treatment of haircuts for maturity originates directly from the implementation of the CRD. The guidelines aim to better align those requirements with	No change

		industry practices, by waiving this requirement in cases where the maturity is actually kept longer than one year.	
Paragraph 19	Respondents stated that the question remains whether the haircut for maturity should be gradually applied through the first 9 months of the policy period ending at zero 90 days prior to renewal, or whether the haircut should not be applied unless 90 days before renewal instructions have not been given to renew the policy.	The AMA operational risk measure must achieve a soundness standard comparable to a 99.9 % confidence interval over a one year period. It may be necessary to apply the haircut gradually over the first nine months to reflect the assumed holding period within the capital calculation. However, the application of the haircut for maturity can only be decided on by the supervisors, taking into account, <i>inter alia</i> , the content of the insurance contract on terms and automatic renewal, the use of insurance within the AMA bank, insurance market conditions and not least the AMA model. If appropriate, supervisors may decide to waive the need for a haircut for maturity.	Paragraph 19 amended
Paragraph 21	Respondents asked how the guidelines on the uncertainty of payments should be applied to insurance companies which are unrated, or if their rating is lower than the rating of the parent company.	The CRD requires that an insurance contract can only be recognised within the AMA capital calculation if the insurance company providing the contract is rated by an eligible ECAI with a credit quality of step 3 or above. If no, or no sufficient, rating exists the	Paragraph 21 amended

		insurance contract cannot be recognised within the AMA. The CRD doesn't contain a rating requirement for parent companies of insurance companies providing insurance cover to be recognised within the AMA. The rating requirement is described in paragraph 12 of the guidelines in more detail.	
Paragraph 21	Respondents commented that the haircut for mismatches should take into account the scenarios which have a significant influence on AMA capital and should not stem from an internal loss data base.	The internal loss data collection contains information on losses and recoveries. As long as the internal data is relevant as required by Annex X, Part 3, No. 15 and No. 18 of the CRD they often provide the basis for the capital calculation including the calculation of the capital alleviation stemming from the use of insurance within the loss distribution approach. Depending on the AMA model and the contribution of loss data and scenario analysis on the capital calculated, scenario analysis may have a significant impact on the risk profile and therefore possible mismatches of potential insurance cover need to be considered within the scenario analysis.	Paragraph 21 amended