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The Deputy Director General

Paris, 15 February 2006

FBF response on revised Consultation Paper CP10 : Guidelines on the implementation, validation and assessment of Advanced Measurement (AMA) and Internal Ratings Based (IRB) Approaches.

Dear Mrs Nouy,

The French Banking Federation (FBF) welcomes the opportunity to comment on the second CEBS' consultation about the implementation, validation and assessment of Advanced Measurement and Internal Ratings based Approaches even though we have been surprised by the short period the CEBS allowed for this second consultation.

The current CP10 revised text still remains confused on some issues especially in new paragraphs introduced by the proposal.

- The documentation required (procedures, processes, policies...) for the internal practices of a group and all of its entities is excessively detailed and does not add value in home/host issues.
- Banks are concerned with the burden and cost of translation. Policies, internal models processes, systems are numerous and their full documentation can not be gathered within the comprehensive application file which CEBS refers to. We recommend that no more than two languages may be requested for the most basic documents and that only the operational language should be used for the more technical processes and associated documentation and procedures.
- On specific items (securitisation, purchased receivables, downturn LGD), the FBF would like to have more explanation to clarify the CEBS demands (method, calculation, perimeter ...) that are unclear for the industry.

Mrs Danièle NOUY
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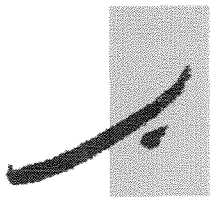
- For operational risk, we urge the CEBS to consider that it could be stronger incentives to move back to the standard approach than to go forward with AMA if the cost of implementing a compliant framework is beyond what banks can reasonably afford.

Please find our detailed comments enclosed.

Yours sincerely

Pierre de Lauzun

A handwritten signature in black ink, appearing to read 'La 27', located below the printed name.



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Detailed comments of the FBF on CEBS CP10 revised

GENERAL COMMENTS

FBF welcomes the opportunity to comment on CEBS' new CP10 document. We understand that this paper must be considered as guidelines not only for national competent authorities but also for credit institutions. We appreciate that a lot of questions raised by the first CP10 have been answered in this version. Nevertheless, some issues still need to be addressed or have emerged with the new paragraphs introduced in the paper.

SPECIFIC REMARKS

§ 67: Banks are concerned with the burden and cost of translation that this paragraph could impose. Policies, internal models processes, systems are numerous and their full documentation can not be gathered in multiple languages for the sake of the comprehensive application file which CEBS refers to. We recommend that no more than 2 languages may be requested for the most basic documents and that only the operational language is used for the more technical processes and their related documentation and procedures. Only summaries and abstracts should be made available in a handy manner.

SECURITISATION

Concerning boundary issues with specialised lending, **§187d** refers to Annex III in case of uncertainty. To be consistent with the text of the CRD, we propose to change in Annex III 4) the words "direct control over the physical collateral" by "substantial degree of control".

With regard to the indicator of significant risk transfer, we understand that its assessment has to be left to the supervisory discretion which will be based on a case-by-case approach. **§187m** suggests that a quantitative threshold could be based on the percentage of losses (EL + UL) retained by the originator. We believe that such threshold should be made consistent across Europe and discussed thoroughly with the Industry before being set.

PURCHASED RECEIVABLES

The text is still unclear about the seller's default and its link with dilution risk. It is said in **§188t** that dilution risk refers to the possibility that the potential amount of receivables bought and financed by the institution may be reduced on the initiative of the seller. Examples are given: "offsets or allowances arising from return of goods sold, disputes regarding product quality, possible debts of the borrower to a receivables obligor and any payment or promotional discounts offered by the borrower". We must have in mind that these losses only materialize when the seller is in default: in most cases, when he is not, recourse exists and he has to pay back the difference between what is due to the bank and what has been received by the institution.

Besides, in case of seller's default, some preferred creditors may have a senior claim on the proceeds, which reduces the bank's recovery. Actually, the seller's default risk plays a significant role which should be more clearly defined.

DOWNTURN LGD

The text gives more information about downturn LGDs. We understand that downturn LGDs is deemed to be calculated during conditions where credit losses are expected higher than average and not where default rates are higher (**§219b**). This LGD is used to calculate risk-weighted exposure amounts for non-defaulted exposures and expected loss EL (to be compared globally to specific and general provisions) (**§239b**).

FBF still disagrees with the concept of downturn LGD. We are concerned that the downturn LGDs proposed in the paper will lead to excessively conservative LGD estimations. First of all, estimating meaningful downturn LGDs for wholesale portfolios cannot be derived from actual data since most banks have limited internal default history. Second, these LGD cannot be used in banks' daily risk management processes like economic capital calculation, pricing or management reporting and generally fail the use test. Furthermore, they will lead to confusion amongst stake holders analysing the information under Pillar 3. Last, this would reduce banks' incentives to move from the F-IRB approach to the A-IRB approach.

The text tries also to clarify the definition of LGD versus EL_{BE} on defaulted assets, but it still remains very confusing. It is said in **§239e** that LGD for defaulted assets must be the sum of EL_{BE} and an add-on reflecting possible additional unexpected loss during the recovery period, where EL_{BE} shall be the credit institution's best estimate of expected loss for each defaulted exposure given current economic circumstances (according to *Annex VII, Part 4, §79*). So we may assume that 1/ EL_{BE} represents specific provisions on this particular asset and 2/ this LGD is supposed to cover expected losses and unexpected losses and is not connected with LGDs which come from the models and are applied to non defaulted exposures:

- ✦ This LGD is not used to calculate EL because CRD says that for defaulted assets EL shall be EL_{BE} (*Annex VII, Part 1 §28*),
- ✦ The text says also that for each defaulted IRB retail exposure and each defaulted A-IRB corporate exposure (except exposures under the double default treatment), RW shall be:

$$\text{Max} \{0, 12.5 * (\text{LGD} - \text{EL}_{BE})\} \text{ (Annex VII, Part 1 §3 \& §9).}$$

So, we can conclude that:

$$\text{RW} = \text{Max} (0, 12.5 * \text{add-on}_{UL}).$$

How this add-on should be calculated? What is the connection with LGD calculated with historical data? Why must we apply this treatment on an individual basis, even on retail exposures? That makes no sense where the provisions are established on a statistical basis for a whole portfolio.

We can understand that some defaulted assets require a capital charge but we are not sure to understand the global consistency of the framework. **FBF urges CEBS to be more explicit on the calculation of LGDs and RWAs on defaulted assets.**

SUPERVISORY CONVERSION FACTOR VERSUS OWN ESTIMATES

§257 to 261 give more clarity about the use of CF and answer to most of our questions. In our understanding, own estimates of CF must be calculated for retail exposures. For corporates, sovereigns and institutions, the credit institution must be permitted by competent authorities to use own estimates of CF for credit lines, short-terms letters arising from the movement of goods, undrawn purchase commitments, note issuance facilities and revolving underwriting facilities. We also understand that for other off-balance sheet items, i.e. guarantees and stand-by letters of credit given by the institution, supervisory conversion factors must be used.

We think that own estimates of CF can be estimated without too much difficulties from our historical data for undrawn credit lines or exposures similar to credit lines. We welcome the initiative taken by CEBS to impose regulatory conversion factor for guaranties given by the bank because it is nearly impossible to calculate own estimates for these products.

Therefore, we do not understand why for short-terms letters arising from the movement of goods, which are similar to guaranties given by the bank, it is not possible to use supervisory conversion factor on a permanent basis if the bank is in an A-IRB approach for the other products. **We ask CEBS to permit the credit institution to apply the same treatment for short-terms letters arising from the movement of goods as the one applied to guaranties given by the banks, that is to say, to use supervisory CF.**

OPERATIONAL RISK

General comments

Our view is that the document is particularly detailed and is too prescriptive for some key points of the AMA, in particular those concerning correlation assumptions¹.

We do think that the text is too quantitatively oriented and driven; it does not take into account the practicality of AMA. The AMA measurement framework should be sufficiently robust and closed to business decision making by both the management bodies and the operational risk practitioners. Moreover, there should be a clear capital incentive and an economic case to move from the forfeited approaches to the more sophisticated AMA.

In this regard, we are afraid that the cost of implementing a compliant framework goes far beyond what banks can reasonably support, specifically in an initial implementation phase. The end result could be a general disaffection for the only risk sensitive and management oriented approach.

Comments on new AMA Quantitative sections

§437: We still believe that providing examples brings more drawbacks than benefits and recommend once again to delete them.

§442 2nd bullet point and 445 3rd bullet point: We suggest changing the sentence in § 442 2nd bullet point to "a review of the systems by which the institution ensures data quality standards".

Although cross-checking against material accounting data is cited as an example of activity aiming to improve the data quality standards, in § 442 regulators set as a minimum standard for internal audit to review the system for cross-checking against accounts. We feel this effectively turns the example into a requirement. It should remain an example.

¹ See §462 a, last sentence and Annex 8.

§456: We recommend replacing “loss events database” with “operational risk data”. We feel that this is a broader term avoiding implicit suggestion that loss events are directly injected in the capital calculation.

§456g & 456h: The distinction between "multiple-effect losses" and "multiple-business lines losses" remain partly unclear; only "multiple-effect losses" are referred to in §456k, and "multiple business lines losses" in §456n: rationale for such different specifications should be exposed in more detail, or the distinction between the two categories of losses should be removed.

§456k: The sentence: "Multiple-effect losses should also be aggregated into a single loss before inclusion in the calculation data set" is overly prescriptive, and does not account for possible situations where other calculation methods could be justified (i.e., multiple-effect losses impacting entities related to different business lines in different countries, with different risk profiles; in such cases, frequencies of the losses are perfectly correlated but severities are not necessarily). We recommend this sentence be completed as follows: "Multiple-effect losses should usually be aggregated into a single loss before inclusion in the calculation data set; possible exceptions should be documented by institutions."

§456n, second bullet: similarly to the preceding, the sentence: "In any case, the aggregated amounts, and not the pro-rated amounts, should be included in the calculation data set" is overly prescriptive, and does not account for possible situations where other calculation methods could be justified (i.e., multiple-effect losses impacting entities related to different business lines in different countries, with different risk profiles). We recommend this sentence be modified as follows: "The aggregated amounts, and not the pro-rated amounts, should usually be included in the calculation data set; possible exceptions should be documented by institutions."

§456g: We suggest the example “for example by linking thresholds to risk tolerance” is deleted as it implies that risk tolerance is currently set against levels of accepted/unaccepted loss, which is not the case.

§456r: We suggest the example “for example by making use of appropriate distributions and suitable parameter estimation procedures ” is deleted as it implies that historical loss data is used in the data calculation set which is possibly not the case.

§456t to 456v (External data): We have no comments on external data, but we agree that it is focused on consortia data. However, too much focus could be interpreted as an incentive for institutions to participate to consortia initiatives - such recommendation being not in line with the purpose of the document. We suggest this paragraph be rewritten in a summarized way, stating clearly that participating to consortia initiatives is up to the institutions and not an issue for regulators. We believe that § 456w and 456x, provided they are generalised to all types of external data, would suffice.

Scenarios: we support the general comment on more flexibility in these paragraphs to avoid implying a given approach.

§457: We support the view that the term “repeatability” should be clarified to refer to the process and not the outcome of the scenario.

§457a, 2nd paragraph: We believe that the concept of “granularity of a scenario” should be clarified or removed. We assume “granularity” means the business lines, territories, entities, units, etc. in which the scenario is applicable and should be studied. We suggest this

paragraph be re-worded to avoid placing emphasis on a statistical or empirical approach to choosing a level of granularity to scenarios. Sentence could read: "Institutions should be able to explain the rationale behind the level at which scenarios are studied and/or the units in which they are studied."

§457b & 457c: In §454, the Revised CP10 has modified with full justification the initial document by stating that "all 4 elements (are to be used) as inputs to (institutions') operational risk measurement systems" rather than "operational risk capital requirements model" in the previous version. However, the new §457b and §457c do not seem in line with this modification, as different sentences could be understood as advocating for a direct input of BE&ICFs in the model itself: "BE&ICFs can be incorporated into the AMA model in different ways..." (§457b); "Institutions should document where in their model they use BE&ICFs" (§457c). We suggest to replace "model" by "system" in these two sentences - which is in line with prescriptions in §457d.

§461e & f: The steps suggested in this paragraph are typically steps applicable to an LDA approach based on historical data. They do not fit steps taken in other approaches, particularly SBA or a hybrid approach. For instance "goodness of fit" diagnostic tools are not well adapted to SBA; however, other methods are chosen to achieve the same goal (for instance comparing historical data with potential loss data). We suggest that these steps be removed or, similarly to § 461D, it be emphasised that the following steps are "intended to be non-binding". We strongly recommend Annex V to be removed as it is far too prescriptive.

§461g & h: We strongly recommend that Annex VII be removed.

Specifically, the last bullet point in Annex VII is unrealistic as it presumes that banks have calculated op risk capital many times and are in a position to observe its variability across time. This is not the case at the present as most banks have not begun the parallel run.

Assuming the third bullet refers to the statistical error of the VaR as a result of the estimation error of the parameters, this point may prove difficult to implement at this stage depending on the methodology adopted. This is because: (a) it requires banks to have quantified the relationship between VaR and the model parameters that drive the calculated VaR number, and (b) it presumes that banks have used a parameter estimation method that provides standard errors of the parameter estimates. These assumptions can be fulfilled when adopting an LDA approach based on historical data but is far more difficult for any other type of approach. This makes the point too prescriptive and may not be applicable to some of the methodologies employed by some banks.

§ 461g: We are agreeably surprised to read that it is allowed scale up a lower confidence level to achieve the 99.9 percentile.

Expected Loss: We agree that the WGOR should reinstate support for the AIGOR principles-based approach on this matter.

§462a (Correlations): We support the idea that a definition should be given to correlation that broadly incorporates dependencies between risk classes. Certainly the IIF paper on correlations would be helpful at this stage and if possible issued/incorporated.

However, we feel that the paragraph on correlations has three major flaws:

- It focuses on specific and rare cases (tail events) of correlations without addressing the majority of cases.
- It does not account for situations where correlations can be applied with justification. It thus appear contradictory with §461x and the underlying Annex X, Part 3, Paragraph 11 of the CRD.

- It implicitly opens the door to the concept of super-additivity (the concept by which correlation factors between risk classes for tail events could be >1), and in particular the last sentence in § 462a which **we strongly recommend should be deleted as well as Annex VIII**. Super-additivity is one of the aspects of an AMA model that could drive institutions to revert to a standardised approach.

Another suggestion could be to replace the last sentence in §462 with the following: "In particular, institutions should ensure that they do not underestimate the dependencies of the tail events when calculating the overall AMA capital charge."

§463j: Reference is made to Annex VI, instead of Annex V.

§473: Though we share the objective of ensuring that "the overall risk management and measurement processes and systems remain effective over time", we are concerned that this paragraph could question the independence of Internal Audit and, to a minor extent, the ORM function. We would rather suggest: "The operational risk management function and Internal Audit should work, on an ongoing basis, in close cooperation with senior management, to ensure that their control procedures and measurement systems are adequate and that the overall risk management and measurement processes and systems remain effective over time". Either way, we consider that only the "management body" could have an oversight on procedures and systems adopted by Internal Audit.

§474: Though the tasks listed in this paragraph are appropriately under the responsibility of senior management, our views are that the ORM function should be associated to, and be held partly responsible for these tasks. We would then suggest: "Senior management should ensure, in cooperation with the appropriate level of the ORM function, that the following tasks are being addressed."

In addition, we suggest that there should be some reference to a "phasing in" of this list of tasks, as it is unrealistic to imagine that all of these tasks will be implemented within the remaining 2 year time horizon, particularly the last bullet point.

ANNEX V, section 2: We understand that the CEBS' purpose is to norm some of the AMA measurements methods. However, this annex appears too prescriptive, as techniques will continue to evolve to allow for higher quantitative standards and methods; specifically, those methods have to be adapted to the specificities of data collections. We suggest removing this annex or, at least, to modify the text as follows in section 2, "Appropriate techniques for the estimation of the parameters":

The sentence: "Nevertheless, where the data result... not sufficiently large" is overly prescriptive and does not account for specific situations where "Maximum likelihood estimation" cannot be used because the paucity of data and where either the "methods of moments" or the "generalized method of moments" could be appropriate and justified. We suggest replacing this sentence with the following: "Institutions should explain the relevance of the chosen method".

ANNEX VIII: This section is unclear as it focuses on causal information, which banks may or may not collect. This is particularly the case since the Basel categories are event categories rather than causal categories. In addition, the section is excessively complex and arguable, and is less justified with the proposed modification in §462a. **We recommend this Annex be removed, as well as the reference to it in §462.**