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2nd Draft of CEBS "Guidelines on the implementation, validation and assessment of AMA and IRBA"
- ZKA position

The Zentraler Kreditausschuss is grateful for the opportunity to comment on CEBS's 2nd draft of "Guidelines on the implementation, validation and assessment of Advanced Measurement (AMA) and Internal Ratings Based (IRB) Approaches".[1]

General remarks

We welcome CEBS's objective of promoting a common understanding of the minimum requirements for the IRBA and AMA among European supervisory authorities in order to facilitate the use of the cooperation procedures under Article 129 (2) of the CRD and establish a consistent application of rules and a convergence of supervisory practices in the EU. However, the draft guidelines still fail to achieve these objectives. On examining the paper, we unfortunately noted that the heavy criticism of the first draft voiced by both the ZKA and all other European banking associations has been virtually ignored.

When drawing up the guidelines, it should first be borne in mind that a basic principle in creating a single market is to achieve minimum harmonisation in areas of particular relevance to competition reflecting the principle of subsidiarity. We appreciate the inclusion of the new Section 14a in the revised draft in principle. As a result, however, that means full harmonisation is firmly established for the areas covered by the guidelines after a transition period. This section therefore contradicts the intention of European

[1] We should like to point out, however, that our comments are subject to final approval by the relevant committees of the member associations of the ZKA.

legislators, i.e. providing national legislators with explicit degrees of freedom regarding the implementation in national legislation, and also contradicts the principle of proportionality, for all institutions are subject to the guidelines.

National supervisory authorities must continue to have sufficient discretion on matters of detail so that account may be taken of national specificities when transposing European directives. The consistent application of directives and the convergence of supervisory practices in the EU should not lead to a high level of detail and a disproportionately costly additional administrative burden for financial institutions, particularly small banks. This applies all the more in view of the fact that the majority of European banks operate only at national level and benefit from convergence of regulation and supervisory practices at best indirectly. The costs imposed by the high level of regulation also put all EU banks at a disadvantage compared with banks based outside the EU. As far as we know, the Basel Accord Implementation Group is not planning to publish anything similar to the CEBS guidelines

It should, moreover, be ensured that the guidelines do not give rise to rules going beyond what is required under the CRD since the Lamfalussy process gives CEBS no mandate to call into question, let alone modify, democratically legitimated decisions. This applies particularly to areas where European legislators have consciously and for good reasons not adopted some of the Basel framework's more restrictive requirements so that solutions can be implemented in the banks which reflect market realities.

In their present form, the proposed guidelines

- add requirements going beyond the CRD,
- contain a high degree of detail – often without offering additional clarification,
- include a significant level of conservatism,
- are sometimes inconsistent concerning definitions and requirements,
- are sometimes not in line with common modelling techniques or simply impracticable (see in particular remarks on Section 462a),
- are frequently mathematically unfeasible,
- continue to contain impractical restrictions on bank internal governance.

The guidelines should be limited to high-level principles on major issues that are relevant to ensuring a level playing field. Supervisors ought to focus on targets that should be met within the approval process, instead of prescribing detailed steps which will probably impose an additional burden on both supervisors and banks without achieving CEBS's stated objectives.

Specific remarks
Chapter 1 – Introduction

Section 14b.
We welcome the intention to adapt the guidelines in line with the development of the industry standard in the field of AMA and IRB approaches. However, we should like to request, by way of precaution, that reasonable transition periods be allowed to adopt in any changes to the guidelines.

Section 15 a.
Although Section 15 clarifies the scope of application of CP10, the question of EU-Non-EU arrangements remains unanswered and needs clarification

Chapter 2 – Cooperation procedures, approval and post approval process

Section 58
The requirements regarding the "implementation plan" exceed requirements laid out in national regulation. In line with the "good faith clause" (Section 14 a) it should therefore be clarified that no legal consequences are imposed on those institutions whose IRBA application has already been launched on the basis of national IRBA application regulations.

Chapter 3 – Credit Risk

At this point we should like to come back to some issues we raised during the first round of consultation in the second half of 2005. The following important issues are still not regulated in a satisfactory manner.

Approval process. Unchanged Section 74 allows for the validation process to "include off-site analysis or on-site missions, conducted by their own or external staff." This could lead to potential conflicts of interest, in particular if external staff (as confirmed by regulators) is sourced from consultancy firms.

Supervisory practice driving banking practice. Section 198-199: The definitions of realised loss and loss in LGD are unclear and potentially ambiguous. Moreover, we believe that requirements are too granular, especially as regards the data required to calculate economic loss. In this area, we see that there is a reflection of indirect costs in industry practice and that the high level of granularity adds little value. Furthermore, it would be essentially impossible from a technical viewpoint to capture all recovery costs at an entity level. The granularity could in fact lead to an arbitrary inaccurate measurement. The requirements also fail to reflect the development of PDs in relation to LGDs and could act as an obstacle to evolution towards best practices in this fast developing area.

EAD modelling. The EAD modelling outlined in Section 245ff is very restrictive by using CF on the undrawn amount - a common but very questionable modelling approach, which is, for example, not suitable for aval lines. The attempt to accommodate aval products in Section 261 fails as no clear statement is made about what "undrawn" means for guarantees. CP10 effectively removes all potential for applying alternative EAD models.

Unclear scope and definitions. Section 277 lists numerous documentation requirements without differentiating between rating development and parameter calibrations. The text appears to refer only to PD ratings and is not appropriate as a requirement for LGD/CF calibrations/modelling. This paragraph is easily misinterpreted, potentially causing supervisors to ask for the impossible, i.e. a "CF rating system" or "LGD model output calibrated to default probabilities". A request to clarify to which risk parameter the individual positions listed in this paragraph apply has been rejected.
Equally, Section 337 continues to demand that "In cases where lack of data (internal or external data) prevents the proper use of benchmarking and/or backtesting, institutions should apply an appropriate (instead of "higher") margin of conservatism in their estimations." This leaves the definition and measurement of "appropriate margin" entirely open to regulatory arbitrariness.

Implementation burden. The unchanged Section 352 requires that "limitations in the dataset should not exempt institutions from performing a quantitative validation in low-default portfolios". This is a contradiction in terms as a lack of data will not allow useful quantitative validation; the paragraph will thus create unnecessary work.

Section 312f. requires: Representativeness and/or comparability analysis require **all** key characteristics to be similar. Suggested criteria comprise distribution of the population according to the key characteristics and the level and range of these key characteristics. This is **impractical** as not every single driver can be representative in a development or test sample. The added sentence "Although it is unrealistic to expect a perfect match in every case, the institution should nevertheless ensure that the distributions are reasonably close" is insufficient as the wrong key message ("to require all key characteristics to be similar") remains.

Internal Governance. Despite some changes easing the demand for extreme management body involvement in the governance of the IRB and AMA processes compared to the original CP10, some issues remain.

- Section 385: "the head of the control function should be subordinated to a person who has no responsibility for managing the activities that are being monitored and controlled". This technically implies that risk methodology and validation units may not be part of the risk management function, which is common practice in many institutions.
- Moreover, Section 482 defines processes for the operational risk management function without allowing for these processes to be delegated. A delegation similar to other risk types is to be permitted.

The new sections on credit risk (attempted guidance on securitisation, equity investments, purchased receivables and an incomplete transcript of Basel guidelines on downturn LGDs), while comprising only minor issues, do not add further clarification and are thus superfluous. Nevertheless we have the following comments with respect to the newly included credit risk rules:

Section 187a.
The list of IRB approaches is not exhaustive: Besides RBA and SFA, IAA and the fall-back approach for unrated liquidity facilities (Annex IX Part 4 No. 56 of Directive 12/2000/EC) should also be included.

Section 187f.
It is intended to clarify that an originator who fails to transfer significant credit risk has to “keep the securitised exposures under the retail and corporate exposure class”. This is misleading since in principle exposures from every exposure class can be securitised. We therefore would like to suggest stating instead that the originator will have to calculate risk-weighted exposure amounts for the securitised assets according to the rules for the “respective exposure class”.

Section 187r. ff.
We reject the *de facto* adoption of the Basel Accord definition of “equity exposures” for the EU. Instead, the definition in Article 86 No. 5 of Directive 12/2000/EC, which has already been used as the basis for national implementation in Germany, should be retained. A less rigid definition gives flexibility to institutions to establish adequate criteria and processes to delineate between credit and equity exposure. This flexibility reflects the general Pillar II idea of proportionality and gives flexibility to efficiently respond to changes in the market environment.

Products with debt- and equity-characteristics (e.g. mezzanine) are an important and dynamic market segment. Therefore, regulatory rules for the categorization of these products need to provide sufficient flexibility to keep up with the development of new products and structures in the market. Market judgement regarding these products takes several dimensions into account to determine the degree of equity (see for example "Moody's Toolkit: A Framework for Assessing Hybrid Securities", Dec. 1999, which analyses products along the dimensions "maturity", "loss absorption" and "No ongoing Payments" to place these on the "debt-equity continuum") which are not static. The proposed mostly one-dimensional guidelines are not suitable for this purpose and might interfere with market developments (e.g. missing maturity – Section 187u (1)). Therefore, these criteria should not be introduced via CP10.

To prevent “gaming”, banks should be asked to introduce transparent and auditable internal processes and criteria for the classification of debt and equity products.

The inclusion of indirect equity exposures, i.e. “holdings in corporations, partnerships, limited liability companies or other types of enterprise which issue ownership interests and are engaged principally in the business of investing in instruments” is, moreover, unclear. This poses problems particularly on a solo basis. If, for example, holdings in

"financial enterprises" (Art. 4 No. 5 of Directive 2000/12/EC) were not deducted from equity, the holdings of the financial enterprise would have to be treated by the bank in the IRBA within the framework of a "look-through" approach. We reject this, as the bank's loss is limited to the amount invested in the financial enterprise. The "look-through approach" would, moreover, constitute an additional "partial consolidation" that is not offset in supervisory terms by any gain in knowledge going beyond group reports.

Section 187u.
At first glance, all instruments with the same structure as an instrument accepted by banks as Tier 1 capital are to be included as equity exposures. We should like to point out in this connection that the term "Tier 1 capital" does not appear in Directive 2000/12/EC. Reference should be made instead to the capital components in Article 57 a)-c) of Directive 2000/12/EC.

According to the second bullet point (1) an instrument should be categorised as equity if the issuer may defer indefinitely the settlement of the obligation. From our point of view, the fact that the issuer may defer indefinitely the settlement of the obligation should not automatically classify a product as equity. Classification should be based on a broader analysis of the instrument and not on single features. According to Moody's analysis, for example, perpetual preferred securities can be closer to credit than to debt depending on other features of the product. (see "Refinements to Moody's Tool Kit: Evolutionary, not Revolutionary!., Feb 2005, p.6).

Section 187x.
We reject the CEBS's proposal to assign convertible bonds to the equity segment. Since the conversion of the bond into shares / equity is only an option, the exposure should be treated as any bond, as long as the option is not exercised. Only after conversion of the bond into shares would the exposure be assigned to the equity segment.

Section 188 ff.
The criteria governing the use of certain approaches for the treatment of exposures are described adequately in Annex VII, Part 1 No. 15.Additional criteria ("approach should be chosen according to the general principle of adequacy and proportionality.", "choice made by the institution should reflect the size and complexity of exposures as well as the expertise available within the institution.") should not be introduced.

Sections 219 a.-b. und 239 a.-d.
These sections are in essence excerpts of the BCBS principles paper. However, the clear BCBS statement (Section 115, p. 10) in favour of banks: "No material adverse dependencies between default rates and recovery rates have been identified through analysis ..., the LGD estimates may be based on long-run default-weighted averages of observed loss rates or they may be derived from forecasts that do not involve stressing appropriate risk drivers" but should be included in CP10. Moreover, statements like "While institutions are building better data sets and developing more experience in estimating downturn LGDs, supervisors may choose to direct them to focus their efforts on types of exposures for which they believe the downturn effect is of special concern." (in Section 239a) open the door to regulatory arbitrariness.

Identifying appropriate downturn conditions for the entire portfolio on the basis of internal empirical data is highly unrealistic. Even more unrealistic is identifying downturn conditions for each supervisory asset class and each jurisdiction since the number of defaults and recovery proceeds for several asset classes/jurisdictions is very small.

Many institutions use a bottom-up approach for the calculation of LGDs, i.e. downturn conditions are already reflected in the collateral values. As a consequence, experts do not expect substantial changes in the recovery rates due to an economic downturn. Furthermore, rating systems are often designed as point-in-time ratings. Therefore, most of the effects of an economic downturn should be reflected in the rating expression and not in the PD per rating grade.

The attempts in Section 239e.to explain why downturn LGD are not to be used in assessing the EL for defaulted exposures, just highlights the absurdity of the downturn LGD concept.

Section 306
This paragraph states that data quality could be reviewed by replicating the preparation of data and model output based on a sample of data. The data sample as well as the review process could then be audited by the supervisor. This process could mean unnecessary duplication of data preparation (original *and* sample data has to be prepared; the later is checked by the supervisor). No duplicate data preparation should be required for supervisory review purposes.

Section 312
This paragraph states that institutions should demonstrate the comparability of data sets by means of analyses of the population of *exposures.* This requirement raises practicability issues since exposure information is generally not provided with ratings of ECAIs or pools.

Section 340
We would like to point out that there is an inconsistency between specific guidelines set out in Section 340 and more general principle guidance (principle 5, Section 333): Section 340 states that institutions should take action if internal validation thresholds (i.e. derived from confidence intervals) are exceeded; thus, Section 340 could be interpreted as “hard” thresholds for backtesting. Principle 5 comprises both quantitative <u>and</u> qualitative elements for validation. This is stressed in the context of benchmarking and low default portfolios. Thus, “hard” thresholds for backtesting or benchmarking results (as set in Section 340) contradict principle 5.

Section 360
It should be clarified that for small institutions an adequate control process is sufficient and no separate organizational unit is required.

Chapter 4 – Operational Risk

There are many paragraphs which do not contain any rules in the real sense but are more of a descriptive nature and achieve a level of detail that is out of place in supervisory regulation. We would refer in this context particularly to Annex V as a whole, the purpose of which is unclear to us. We would not expect a supervisory authority to provide examples of operational risk modelling. We wish to stress again that experience shows that so-called examples are interpreted as more or less mandatory best practices. For this reason, we are in favour of dropping Annex V in its entirety.

Section 417
In case of partial use TSA and BIA institutions are supposed to meet the TSA qualifying criteria for all business lines. It follows from this that BIA business lines will also have to be subject to complex standards. This contradicts the idea of a partial approach, since a bank will only opt for partial use for gross income segmentation reasons only. We therefore believe that the qualitative requirements of each approach should also be applied to the corresponding business lines, i.e. compliance with BIA requirements must be sufficient for BIA business lines.

Section 429
According to Appendix X, part 4, paragraph 2 of the CRD, national authorities should be able to impose additional requirements for partial use of an AMA (minimum threshold upon introduction and obligation for complete "roll out") on a case-by-case basis. However, Section 429 expresses the expectation that additional requirements are to be imposed in most cases. The CRD provides for permanent partial use as the typical case, even for material units. Consequently, the CEBS proposal cancels out the purpose of the CRD, is not covered by the CEBS mandate and should be dropped.

Section 445
Regularly cross-checking material accounting data against operational loss data is unnecessary and also uncustomary in practice as the material loss data already have to be cross-checked against the accounting data (see Section 442). On the contrary, such an additional requirement imposes a burden that is in no proportion to the result (supposedly broader coverage of loss events). We also wish to point out that this is an additional requirement on top of the CRD, as it has no equivalent in the directive. We are therefore in favour of dropping this requirement.

Section 448
In our view, the requirements of Section 448 regarding data documentation are inappropriate. Database descriptions und statements of IT system weaknesses do not contain any additional information about the accuracy of the data used. Therefore, we suggest dropping the requirements regarding database descriptions and statements of weaknesses.

Section 455
The wording of Section 445 is unclear and does not contain any precise requirement. We therefore suggest deleting Section 455.

Section 456j.
According to the first sentence in Section 456j, losses and recoveries stemming from insurance policies should be recorded separately in the database. We would suggest rephrasing as follows: "Institutions should be able to separate OR events (e.g. loss, recovery) related to existing insurance policies in the calculation data set.

The proposed possibility to record net amounts in the case of rapidly recovered loss events is not customary in practice and the advantage of such an approach is unclear. We therefore suggest deleting the lines in question.

Section 456l.
The development of procedures to detect incidents or near misses is not addressed in the CRD and is thus an additional requirement. We reject such a requirement.

Section 456n.
All examples describe the assignment on a loss-event level. Is it intended to rule out other possibilities? If not, the following example could be amended: Capital figures calculated for a centralised function can be assigned to the affected business lines in a well-documented way.

Section 456p.
The content of Section 456p is purely descriptive and is not a precise requirement. Furthermore, it is not dealt with in the CRD. We therefore suggest deleting it.

Section 456z.
The scenario analysis is normally used for obtaining figures for tail events; the intention in Section 456z seems to be establishing scenarios for "normal" events. This interpretation is at odds with the basic intention of scenario analysis, which is for scenarios to replace missing data points in the tails. For this reason it should be made clear that in certain approaches scenario analysis may be used to expose the institution's overall operational risk.

Section 457a.
We should like to stress that it is simply not possible to prove the granularity or granularity assumptions regarding the number of scenarios in a statistical analysis. We suggest deleting Section 457a.

Section 459.
The purpose of tying usage of qualitative data to the requirement " … to be built by specialists …" is unclear. This point should therefore be deleted.

Section 461c.
According to Section 461c, loss events and loss amounts within operational risk classes should be independent and identically distributed. Dependent loss events within a risk class can be modeled by using a negative binomial instead of a Poisson distribution for frequencies as well. The section should therefore be reworded as follows: "Institutions

should seek to identify operational risk classes within which loss amounts are independent and identically distributed. Alternatively, institutions may wish to adjust their data for known drivers in order to simplify the modeling process, which needs to be justified. “

Section 461i/j.
The reason for the introduction of an internal holding period is not explained. This only creates additional complexity. We would also point out that the CRD does not contain any rules whatsoever on this, so that an additional requirement is again being created here. Finally, we wish to add that no such supervisory approval of internal calculation methods is justified even under Pillar II. It should therefore be removed.

Section 461l.
The recommendation in Section 461l to use a historical observation period longer than five years for low-frequency operational risk classes is not covered by the CRD. We therefore suggest deleting Section 461l.

Section 462a.
Section 462a calls for the AMA capital charge to be calculated as at least the sum of the individual risk measures. This already very conservative calculation method is only possible, it states, if it can be demonstrated that dependencies of tail events are not underestimated. It can be concluded from this that the existence of dependencies of tail events is regarded as a frequent phenomenon.

The consequence of this requirement is that the central idea of reducing risk through diversification is ruled out for the AMA. Such a premise therefore means that AMA modelling cannot produce any more risk-sensitive result than a calculation under the Standarised Approach. This cancels out the effect of the key Basel principle of the “continuum of approaches”. The CEBS's guidelines would prevent banks from using an AMA as the more sophisticated approach would result in a dramatically higher and unreasonable capital charge compared to the BIA and STA. The assumption underlying the requirement, namely that a possible existence of dependencies of tail events is not already covered by the total value at risk, is merely inferred mathematically in the leading academic literature[2]. There is absolutely no proof of its practical relevance. A supervisory rule must, however, cover normal cases and not simply anticipate purely theoretical phenomena. It should also be pointed out that dependencies of tail events can only occur in the case of quantiles of over 99.9%. However, the supervisory discussion only revolves around quantiles of 99.9%, so that this requirement cannot therefore have any relevance for the AMA.

Last but not least, we would refer to the supervisory requirement that losses with the same cause must be grouped to one single data point, which is – again – an argument that tail events should not show any dependencies.

[2] Embrechts, P./Puccetti, G. (2005): „Aggregating Risk Capital, with an Application to Operational Risk“.

For these reasons, we request deletion of Section 462a and Annex 8.

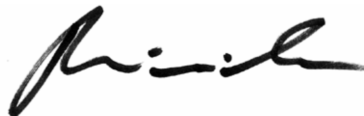
Section 463j.
"Section 463j stipulates that all data above the threshold set must be validated to ensure they are comprehensive, appropriate and accurate." This requirement is hard to understand as it is followed by wording to the effect that banks, after having set low thresholds, are required to validate all loss events exceeding this threshold to be able to use these in a model. However, those losses hardly influence the quantile and therefore the capital measures. This requirement thus merely results in a considerable amount of bureaucracy, which does not positively influence the quality of the capital measure. We propose rephrasing this section in the following way "…only material loss events should be validated

Yours faithfully,

For

ZENTRALER KREDITAUSSCHUSS

Bundesverband der Deutschen
Volksbanken und Raiffeisenbanken e.V.

i.V. 

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